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TAX TREATMENT OF CERTAIN FARM INDEBTEDNESS

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 1041

JULY 28, 1989

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TAX TREATMENT OF CERTAIN FARM INDEBTEDNESS

FRIDAY, JULY 28, 1989

U.S. SENATE,
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:15 a.m. in room SD-215, Dirksen Senate Office Building, Hon. David L. Boren (chairman of the subcommittee), presiding.

Also present: Senator Dole.

[The press release announcing the hearing follows:]

[Press Release No. H-45, July 20, 1989]

FINANCE SUBCOMMITTEE TO HOLD HEARING ON TAX TREATMENT OF CERTAIN FARM INDEBTEDNESS

WASHINGTON, DC—Senator David L. Boren (D., Oklahoma), Chairman, Subcommittee on Energy and Agricultural Taxation, announced Thursday that the subcommittee will hold a hearing on the tax treatment of debts that are canceled when farmers attempt to restructure their loans.

The hearing is scheduled for *Friday, July 28, 1989 at 10 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

"The ability of farmers to renegotiate troubled loans is essential to the preservation of family farms. But under current law, farmers in certain circumstances may have taxable income when they transfer an asset to a lender in order to cancel a debt," said Boren.

"Congress never intended for the Federal Government to penalize farmers for trying to save their farms," Boren said. "These hearings will allow us to explore possible ways to address this problem."

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA

Senator BOREN. Well, good morning. Welcome, Senator Kassebaum and our other witnesses.

We are here today to discuss a number of very serious problems facing America's family farmers. As a member of the Agriculture Committee and as the past Chairman of the Farm Credit Subcommittee, I am very much aware of the financial burdens our farmers are currently facing.

In an attempt to address some of these problems, the Agricultural Credit Subcommittee wrote a broad restructuring provision into the Farm Credit Act that we passed in 1987. It was our intention to help America's farmers avoid bankruptcy by allowing them and the various financial institutions the flexibility to restructure their enormous debt when it was less costly to the taxpayers to do so.

The Agricultural Credit Act of 1987 helped stop the vicious cycle we were experiencing in our part of the country where declining farm land values led to more foreclosures, more land sales, and therefore, still lower land values. But obviously, there is still much work to be done.

Today a farmer seeking to avail himself or herself of the various means of restructuring debt may yet find himself facing an insurmountable tax liability. Typically in the past when a farmer sought to restructure and the lender was willing to discharge certain debts, any discharged debt over the amount of the farmer's basis in the property and his or her tax attributes was treated as non-taxable income. Today as a result of a technical amendment in last year's tax bill, and let me say I think a very mistaken amendment, a farmer who seeks to restructure his debt is likely to find himself facing a tremendous tax liability on phantom income that he obviously never received.

Current law limits a farmer's ability to exclude from taxable income discharged debt only to the extent of his basis and the using of his tax attributes. Now the farmer must treat, under this amendment, as taxable income any amount of discharged debt in excess of basis and tax attributes. So he must now pay taxes on money that he never had.

It would appear that our efforts to help our family farmers avoid bankruptcy have been substantially negated. Can a farmer now seek shelter in Chapter 12 bankruptcy and have the debt discharged under a court order approving a restructuring plan? Will that allow the forgiven debt to be treated as non-taxable income? Apparently not in some states. In Oklahoma, for example, several of my constituents have been informed by the IRS that Chapter 12 or not, they are going to be held liable for taxes on income that they have never seen.

Some agricultural producers and tax specialists suggest a return to the provisions of the 1986 law, and others say that that is not enough. Even under that provision a farmer had to give up his tax attributes first in order to qualify.

Clearly these are problems that need to be addressed, and hopefully today we can come up with some answers. One of the proposed solutions is S. 1041 that would provide not only an exclusion of the discharge of indebtedness income for farmers, but also provides for exclusion for capital gains which might arise when farm property is transferred to a lender in exchange for debt relief.

Senator Conrad has been the principal sponsor of that legislation and I have co-sponsored that bill along with other members of the Senate, both of this committee and the Agriculture Committee.

The issue is certainly a timely one. After a Farm Home moratorium of several years and the implementation of the Agricultural Credit Act, thousands of farmers are now completing the restructuring process. Also, Farm Home Administration is preparing to send out the next wave of delinquency notices soon.

Many borrowers who restructured their loans this year are confused about the rules that apply to them, and those that will soon receive notices will need to be sure of the tax consequences of their options before a sound decision can be made by them about what to do. However, it is important to note that this problem applies to more than just those borrowers restructuring under the Agricultural Credit Act.

So it is a very serious problem and many of us labored hundreds of hours in working on the Farm Credit Act of 1987 to try to find a way to stop this wave of foreclosures. It absolutely makes no sense to force a farmer into foreclosure when it is better for him, better for land values in the economy of the entire region, and better for the taxpayers for that farmer not to be forced into foreclosure.

For example, if you can recover 80 cents on the dollar to the government by restructuring a debt, that makes a lot more sense than forcing a farmer into foreclosure to sell his or her land off at maybe 40 or 50 cents on the dollar with a much greater loss to the government, with the family being thrown off that farm, and with the spiral-declining land values that affects every other farmer in the entire area and the general economy of the area and the health of the financial institutions.

So we acted to do something about it, now to find that through the back door through a technical change that was slipped into the tax bill, at least not to the knowledge of most members of the Finance Committee or indeed any member that I have encountered, we now have the IRS coming in and saying, "I am sorry, but any of that debt that is forgiven or restructured or any supposed gain that results from deeding land back where the farmer is broke, where the farmer does not realize a single penny, is now going to be taxed to the tune of several thousand dollars by treating that gain that he never sees as income."

So this is to me a ridiculous and outrageous situation. It is critical. We are in the midst of restructuring thousands of debts in order to try to end the problem that we have. We have had a lot written about the fact that the Farm Credit Act of 1987 is one government program that is beginning to work. It could be a model for how to deal with the troubled situations, for example, in the savings and loan industry, and now we find that the IRS is coming in under this provision and undermining, or attempting to undermine, the entire program.

So I look forward to hearing the suggestions and comments from my colleagues and our panelists, many of whom have traveled great distances to be with us today. I appreciate the fact that although the Senate is not in session today, and I believe looking at the schedule this morning that this is the only committee meeting, that my colleague from Kansas, Senator Kassebaum would take the time and demonstrate the interest to be with us this morning. That certainly does not surprise me. Time and time again when we have worked to do something to help farmers, whether it is in this area, whether it is in disaster and drought assistance, whether it is work on the farm bill, she has always demonstrated a great interest and concern for the farmers in her State that she represents, and Senator Kassebaum, we are very happy to have you with us this morning and we would welcome your statement.

STATEMENT OF HON. NANCY L. KASSEBAUM, A U.S. SENATOR FROM KANSAS

Senator KASSEBAUM. Thank you very much, Mr. Chairman.

You have some fine witnesses waiting to be heard and I would just like to ask my full statement be made a part of the record and offer a few comments.

Senator **Boren**. We will be happy to do that.

Senator **Kassebaum**. You, yourself, Mr. Chairman, have been a real leader in the regard of trying to redress what is really a tax on going broke, Senator Dole and others of this committee, and it first came to my attention in Kansas in about 1984, I believe, when some Kansas farmers mentioned this particular situation, and I have been interested in this issue since then.

You laid out in your opening statement very clearly what has happened and the current problem. In 1986 when Congress thought they had corrected this problem by a technical correction. We are now having to correct the technical correction, and left unchecked, the technical correction, which we thought had been made to answer the problem, will result in exactly the senseless hardship that Congress set out to correct.

I do not think the issue has changed since 1986, and absent a specific provision to the contrary, farm debt forgiveness will continue to be treated as taxable income. I am very appreciative of you, Mr. Chairman, in holding this hearing. I hope that we can find some means of addressing this in an expeditious manner so that the uncertainty of this situation will not be allowed to continue.

Such tax-driven bankruptcies are senseless and I think continue to devastate the entire rural communities. I think to correct this problem, Congress stated very clearly that there should be no tax on qualified farm debt forgiveness. In this regard, Congress stated that to the extent a farmer had any basis in his assets, it had to be written down. To the extent that farm debt forgiveness exceeded a farmer's basis, the conference report stated it would not be taxed.

Congress voted for the Tax Reform Act on the basis of this conference report. The conference report explanation was accurately transmitted by the agricultural networks and wire services throughout the country. Farmers made decisions as to whether or not to declare bankruptcy based on this conference language. Several months after the Tax Reform Act was signed into law, someone substantively altered the conference report explanation and then justified it as a technical correction.

I am really very pleased that this committee is seeking to correct the so-called technical correction. As a matter of revenue, such an action should be completely neutral. Good tax policy encourages farmers to stay on the farm and out of bankruptcy. Let us waste no time implementing this policy in seeking to redress the situation as it evolved.

Thank you very much.

[The prepared statement of Senator Kassebaum appears in the appendix.]

Senator **Boren**. Thank you very much, Senator Kassebaum.

I would assume that you are being contacted, as I am, by a number of farmers in your State at this moment that are either in Chapter 12 or trying to make decisions about the restructuring plans. Since those notices went out sometime before Christmas last year, during the first half of this year, I would assume that in Kansas you also have a number of farmers who are in the process of working on these restructuring plans with the Farm Home Administration.

Senator **Kassebaum**. Well, I think there is an uncertainty about what the policy will be.

Mr. Chairman, I know that in your good hands and the rest of this committee, the problem will be resolved.

Senator **Boren**. Well, we appreciate you coming very much. I would note that the statement of managers that you referred to in the conference report on the floor accompanying the 1986 Act very clearly said that, I quote from it: "Thus discharge of indebtedness income is forgiven after reduction of basis."

And so, it was very clearly understood at that time—the statement of managers on the 1986 Act certainly made that very, very clear, and there was no notice—certainly there was no notice to me, and I assume no notice to you, as we considered corrective legislation in 1987 that there was anything in that bill that would have changed what we thought was the right of farmers to have a forgiveness of debt which they obviously had no ability to pay without having a tax consequence.

Senator **Kassebaum**. Well, I know you are going to be hearing from witnesses, Mr. Chairman, who have first-hand experience of some of the situations that are occurring, and I think that is a very timely testimony.

Senator **Boren**. Thank you very much.

Senator **Kassebaum**. Thank you, Mr. Chairman.

Senator **Boren**. Thank you for being with us this morning and for taking the time to come and express your interest.

Let me say that Senator Conrad and Senator Daschle have also been very, very active in this legislation. As I mentioned, Senator Conrad introduced the original bill. Senator Daschle has been involved with it, the co-sponsor from the beginning. Both of them are involved in another meeting away from Washington this weekend and were unable to be with us, but they are submitting statements for the record which will be included in the record in full, and they both asked me to express their sorrow at not being able to be with us this morning. I have had hours of discussion with both of them about how we address this problem and they have been very, very much involved in the solution and were among those that urged us to take action.

Senator **Boren**. Let me ask now if the members of our panel would come forward, Mrs. Judy McLearan, farmer/rancher from Skiatook, OK. If you would come forward, Mrs. McLearan.

Mrs. Sarah Vogel, commissioner of the North Dakota Department of Agriculture from Bismarck, ND; Dr. Neil Harl, the Charles Curtiss distinguished professor in agricultural and professor of economics at Iowa State University in Ames, IA; and Mrs. Sharon Watkins, public accountant, Watkins Tax Accounting Service, testifying on behalf of the National Family Farm Coalition from Lexington, IN.

We are very happy to have all of you with us this morning. The Chair never entertains any favoritism. As the members of this committee know, I would never think of tilting a little bit toward Oklahoma in any matter that came before the committee, but I know you will forgive me if I allow Mrs. McLearan to lead off the testimony today since she does come from God's country——

[Laughter.]

Senator **Boren** [continuing]. And hear from her.

I think what we will do is hear from each one of you, and then after we have heard from you, I will pose questions to all of you together and we can share our thoughts and make this as informal as possible because, after all, our purpose is to try to deal with this problem and deal with it in a way that will really help the farmers.

It is cruel and unusual punishment to hold out hope to people of being able to get out from under this huge burden of debt, restructure their debt, reorganize their assets in a way that they can make it and stay on the farm and have one part of the law say, "Here is an avenue of escape for you. Here is hope. Here is a way that you can put your affairs back in order and make it," only to have what you have given with one hand, taken away with the other hand by this overhang of a huge tax liability which wipes out the benefit of doing anything positive.

So we look forward to hearing your thoughts about how we can correct it, whether or not the Senate bill that is before us is sufficient or if additional steps need to be taken as well.

Mrs. McLearan, we are very happy to have you with us this morning. Welcome to the committee.

STATEMENT OF JUDY KENNEDY McLEARAN, FARMER/RANCHER, SKIATOOK, OK

Mrs. **McLearan**. Thank you, Mr. Chairman.

I would like to thank you for the opportunity to come before you and testify, not only on my behalf, but the other farmers. We consider this to be a very vital issue if we are going to stay on farms and farm.

My husband and I farm approximately 2,000 acres of soybeans in the Skiatook and Bixby and Tulsa area, and farming has been our sole source of income for 30 years. From 1982 through 1988, due to weather conditions, we had crop failures. The years we did manage to have a decent crop, the price we got for our beans was not sufficient in order for us to satisfy our debt. So therefore, we just had to continue borrowing to operate and put the next year's crop in.

If we could find a buyer for some of the land to sell off to satisfy the debt, the Oklahoma economy was so depressed, as you know——

Senator **Boren**. Yes.

Mrs. **McLearan** [continuing]. That we could not get enough for our land to satisfy the debts.

So gradually our debt exceeded our income and the value of the land and equipment. Then the bank asked for a large payment on our loan and we were unable to refinance.

We had been for several months inquiring and receiving information on Chapter 12 and had finally decided as a very last resort if we were going to save our farm to seek relief from foreclosure under Chapter 12. We filed in January 1988. The plan was approved in October 1988 as a 1-day plan. We were totally secure. We had paid off all unsecured creditors. We went from loans of 6 and 7 percent to 12 percent loans under Chapter 12.

Part of our plan was a deed-in-lieu to Citizens Security Bank in Bixby for our large loan. At that time we had a verbal agreement that the loan would be totally secure with the collateral. However, the bank asked for new appraisals. So therefore, we had to have new appraisals made. Of course, the appraisals were completely different. So therefore, we had to go back into court and spend the time and the money and the judge set what he considered was a fair-market value.

This loan was $600,000, plus interest. The judge set it at $450,000. The bank got a very, very valuable piece of land on 121st Memorial——

Senator BOREN. Oh, yes.

Mrs. MCLEARAN [continuing]. Which I believe you know what that is, for $450,000, and we were left with $227,000 debt at 12 percent interest to the bank. This then generated a 1099 from them as ordinary income. So we will be taxed as ordinary income on $450,000 gain.

Obviously, we cannot pay this and continue to farm. We have simply traded one debt for another debt and we are going to be right back into bankruptcy and probably complete liquidation.

When our CPA told us that under his understanding the normal rules under 108G would not apply, he advised us to seek advice from tax attorneys. We did this and they concurred with our opinion. We also started seeking help in other ways, mainly from Ron Johnson with Oklahoma Family Farm Services, and we have learned of your pending legislation.

We then filed for an extension until August on our taxes based upon this pending bill, and we will now have to file for an extension until October 15th. That is all the longer we have.

We had both our CPA and tax attorney go over this bill thoroughly. We have conferred with other CPA's and tax attorneys around the State of Oklahoma, including Nellie Perry, and I believe you have her written testimony. They have all come to the conclusion that this bill as written may not—we are not positive—may not be of help to us or any other farmers in this situation because of the net worth requirements and the use of the tax attributes.

The reasons and the changes we would like to propose are outlined in two letters I have attached from our tax attorney and our CPA, but I would like to briefly just state a couple of facts.

[The letters appear in the appendix.]

Mrs. MCLEARAN. If I have to use up all my tax attributes, which include my net operating loss, I will not be able to operate in any capacity in the future. If I have to use my NOL to offset this gain under Chapter 12, I will not have my NOL to offset any future income that will enable us to get back on our feet and satisfy our debt.

Senator BOREN. I understand, yes.

Mrs. MCLEARAN. If we have to reduce the basis in our property to offset the remaining gain, then this will just prolong my problem. It will only increase my tax problems in the future because if

I am ever able to sell or if I need to sell any land to satisfy debt, then I will have all the future tax on it.

We desperately, all of us farmers, need to keep our net operating loss and tax basis in our property. This is the only thing that any of us are going on. We have lost everything else due to all the failures, crop failures, we have had. We are all operating this way, and we desperately need to save this.

Also, we feel a provision on equity in the property should be stricken from the bill. According to your formula in the bill, many farmers, we feel, could have more than $147,000 in equity in their equipment, in their land. I think equity is very hard to define, as it differs from appraiser to appraiser, from date to date, and who is appraising for whom.

We also have raised a couple of questions on the Modified Adjusted Gross Income. We would like to clarify that definition and then I refer you again to the letter from my tax attorney because I am not qualified to sit here and discuss it with you.

Senator **Boren**. We will put those letters into the full record, along with your testimony——

Mrs. **McLearan**. Please. I would appreciate that.

Senator **Boren** [continuing]. So we can consider those.

Mrs. **McLearan**. Mr. Chairman, as you are aware, the farm crisis is far from over. In order to save the family farm, we have got to have some help. I feel like there will be more and more farmers facing foreclosure in Chapter 12s because of last year's drought. It is a terribly embarrassing and terribly humiliating thing to go through bankruptcy and it is terribly expensive. We have personally spent over $20,000 to date and this is $20,000 we could have used to service our debt.

If we are left with this tax load and this bill and the changes we would like to see, they do not pass this year, because we have to have this this year, we will probably lose our farm and lose everything we have worked for our entire life.

I want to thank you very much for your time and your attention to this problem.

[The prepared statement of Mrs. McLearan appears in the appendix.]

Senator **Boren**. Thank you very much for appearing, and as I indicated, there is a meeting that has taken all of the Democratic Senators away this weekend. There is a retreat going on, a meeting of all of them, and many others on the other side of the aisle are also away at meetings. But I assure you, they are going to read your testimony.

We have had a lot of discussion about this, members of the Agriculture Committee and members of the Finance Committee. There are three of us that are privileged to be members of both of these committees, both Agricultural and Finance, and we are dedicated to getting the efforts of both committees brought together to try to solve this problem, and your testimony dramatically describes exactly what is going to happen to people. You are not an isolated case.

Mrs. **McLearan**. No.

Senator **Boren**. There are going to be literally thousands of people in exactly the same situation you are in across the country if we do not act, and as you said, we have hoped that we finally stopped this downward slide in our economy in a State like Oklahoma where our real estate values went down 50 percent on the average for farmland in a 4- or 5-year period. That is what helped break so many of the banks and caused problems in the total economy, not just for farmers. It caused problems for everyone else.

Mrs. McLEARAN. Yes.

Senator BOREN. There was this ripple effect, and this attempt at restructuring the farm debt, stopping the foreclosures, stopping the downward drift of land values, has helped our economy to sort of bottom out. But if this is not allowed to work because of the tax consequences, we face another spiral to foreclosures, declining land values. It will have effects on our entire economy, and as you say, we would find that the trouble was not yet over if we do not find a way to fix this problem and get people started back on their feet.

I understand what you are saying about the net loss carry forward as well. I understand that would make it almost impossible then as you do begin to get some income. It would all be taken by the government in taxes and you would not be able again then to be able to meet your current obligation on indebtedness.

Mrs. McLEARAN. That is exactly it.

Senator BOREN. That is a good point. We will certainly take that under consideration.

Mrs. McLEARAN. Thank you.

Senator BOREN. Ms. Vogel, we are very happy to have you with us today, and we would welcome your testimony. As I have indicated, Senator Conrad has been much involved in this legislation, helped to initiate it and I know that he is going to be reading your testimony with interest.

STATEMENT OF SARAH VOGEL, COMMISSIONER, NORTH DAKOTA DEPARTMENT OF AGRICULTURE, BISMARCK, ND

Ms. VOGEL. Thank you, Senator Boren.

As you stated, I am Sarah Vogel. I am the Agriculture Commissioner of North Dakota and I very much appreciate the opportunity to testify on this important issue.

In 1983, as a private attorney I brought a case known as *Coleman* v. *Block,* and it dealt with the foreclosure practices of the Farmers Home. We won the case. There were many years of litigation, appeals, cross-appeals, so on, but the problems of the farmers were not abated. The opportunity to actually cure some of the underlying problems that have built up over these many years came with the Agriculture Credit Act of 1987.

And this act, as you stated, provides farmers with the opportunity to restructure their debt when that is better for the taxpayer, and it also incidentally happens to be better for the farmer, for the Main Street business, for the communities, for the states, and so on.

Senator BOREN. For the government as well if it was a——

Ms. VOGEL. Oh, yes.

Senator BOREN [continuing]. Farm credit system loan because it is——

Ms. VOGEL. Yes.

Senator **Boren** [continuing]. Cheaper for the government.

Ms. **Vogel**. Absolutely. One of the craziest things is they went forward with foreclosures when that was the most costly alternative in monetary as well as human terms.

So we were very happy that the 1987 Credit Act was adopted, but we are concerned that the opportunities provided by that law are being thwarted and brought to a screeching halt in many instances by the tax consequences of the restructurings, liquidations, retentions of homestead, and so forth.

As you stated, on paper it may look as though the farmer may be making money. In actuality, they are not. Senator Kassebaum put it well when she talked about a tax on farm failure, a tax on liquidation.

And the time for adoption of this law is literally now. In North Dakota we are dealing with a vast number Farmers Home and Farm Credit Services cases where we have really a brief and limited window of time within which to finalize restructuring plans with these agencies or else it will go to court to Chapter 12, to Chapter 7, and so forth.

Nationwide, there were 66,000 notices sent by Farmers Home alone last year. They are soon going to be issuing another 16,000. Of the 66,000 sent out last year, more than 31,000 were unable to meet debt restructuring alternatives, and those 31,000 will all face this problem, as will many of the others who were able to restructure.

Contrary to popular belief, including mine for a period of time, I thought that the tax consequences arose when the farmers bought land at high values and then had debt forgiven. In fact, it is generally the ones who bought land when it was lower priced who are most affected. The low commodity prices, the cost-price squeeze, the crop failures, and so forth, and the highest real interest rates this Nation has ever known, all those factors led to the farmer being unable to cash flow. Then when it comes time for some type of resolution through partial deed-backs conveyances, sales or some other means. They find that they owe Uncle Sam an incredible amount in taxes.

Senator **Boren**. Because they had a very low basis to start with.

Ms. **Vogel**. They had a very low basis.

Senator **Boren**. Because they bought that land when it was——

Ms. **Vogel**. That is right.

Senator **Boren** [continuing]. Cheaper. It escalated in value. They may have borrowed against this escalated value, but they had a very low basis in it to start with.

Ms. **Vogel**. That is precisely it.

Let me give a couple examples. One of the first cases that we worked through the Farmers Home restructuring program in North Dakota involved an elderly farmer who owed quite bit of money to Farmers Home. He was ill and he wanted to quit, and Farmers Home was happy with that alternative. It was acceptable to the farmer. It was acceptable to the Farmers Home. Then they did as we always tell them to do, check with a tax accountant. Had he liquidated, this elderly, ill gentleman would have owed $30,000 to the IRS, and meanwhile, his hospital bills are mounting daily. It is just a terrible thing, but he has no option other than to hang on to that farm that he does not want. He is sick and ill and he will die probably before he can make any kind of a resolution, and his sons would like to take it over.

I have another example which I have given in my testimony and I will not go through it. It is a typical, hypothetical case drawn from the files of the Ag Mediation Program at the Ag Department.

The other factor I wish to bring out is that the tax liabilities which are sought to be collected are being sought from people who do not have any money and who do not have any capacity to pay this money. It is a futile act in most instances. In North Dakota we did a study on the tax consequences of these liquidations, and according to this study, 42 percent of the people who responded to the survey had increased tax liabilities. The average increased tax liability was $20,000, and most of the people who leave farming are not moving off to $60,000 a year jobs. They are having a horrible time finding any kind of work and frequently the work that they find is going to be hourly and not highly paid. Some of them would like to go to school and maybe go into a new career. But with a $20,000 or $40,000 or $50,000 tax liability hanging over their head, they are finding it impossible to get that fresh start that the Ag Credit Act was supposed to provide.

I think the bill as a whole is excellent and I fully endorse it. There are several technical changes that are addressed in Annette Higby's testimony, which she submitted in writing from the Center for Rural Affairs. I would endorse those. It is an excellent bill and I do believe time is of the essence.

Thank you.

[The prepared statement of Ms. Vogel appears in the appendix.]

Senator BOREN. Thank you very, very much.

We have been joined by my colleague, Senator Dole, who also serves as a very active member of both this committee, the Finance Committee, and the Agriculture Committee. I do not know of anyone in the Senate that has a deeper concern about farmers and works more effectively on their behalf than does Senator Dole, the distinguished minority leader.

We have worked together on a number of matters to try to help farmers, and much of the farm legislation that we have in place today that benefits farmers bears his imprint.

Senator Dole, we are really happy to have you with us, and he has indicated he would like to hear the rest of the panel before he makes remarks as well.

Dr. Harl, we would very much like to hear from you.

STATEMENT OF NEIL E. HARL, CHARLES F. CURTISS DISTINGUISHED PROFESSOR IN AGRICULTURE AND PROFESSOR OF ECONOMICS, IOWA STATE UNIVERSITY, AMES, IA

Dr. HARL. Thank you, Senator Boren, Senator Dole.

I am Neil Harl of Iowa State University and I appreciate the opportunity to appear here today. I commend you for your interest in this very troublesome subject matter area.

What I would like to do in my few minutes is to place in context the problems that we are discussing today. I believe there are five problem areas, and most of the farm situations that we see deal with one or more of those five. They are so interrelated that it is necessary to look at all five of those areas.

The five, very quickly, are first, the problems of gain on relinquishing property. It may be relinquishing property to a creditor. It may be simply sale of the property with the proceeds remitted to a creditor.

The second is handling the discharge of indebtedness. It often arises in the same transaction. But from the standpoint of tax law, we deal with the discharge of indebtedness in a totally different manner, and I think that is where some of the confusion has entered.

Third, problems with sellers who would like to forgive gain on land contracts to help financially troubled buyers but are inhibited in doing so because they fear tax liability, particularly where it is a related-party situation.

Fourth, those who are inclined to turn to Chapter 7 and 11 bankruptcy because they get a new tax entity and a new start for tax purposes are now discovering that property is being abandoned back to the debtor and some of the decisions of the bankruptcy courts are putting that tax liability back on the debtor and it is destroying the debtor's fresh start.

Finally, the uncertainties of tax treatment in Chapter 12 bankruptcy, and indeed, I think that the McLearan situation that was described so well earlier is in part a problem related to that one. I will summarize my testimony very quickly and ask, Senator, if it could be entered in full in the record.

Senator BOREN. It certainly will be.

Dr. HARL. On the second page of my statement, I distinguish between recourse debt and non-recourse debt. Most of the farm debt today is recourse debt. However, there is a significant amount of non-recourse debt. Commodity Credit Corporation debt, some land contracts, and some cattle-feeding money back in the late 1970's, all were non-recourse. For recourse debt, the difference between the income tax basis of the property and its fair-market value is gain once you relinquish the property and there is no relief from that, not even if you are insolvent. This is a fundamental point that is addressed in Senate Bill 1041.

Now for non-recourse debt, it is the entire difference between the basis and the amount of the debt that is gain.

Senator BOREN. Yes.

Dr. HARL. In recent time a private letter ruling of the Internal Revenue Service has classified even recourse debt as non-recourse after abandonment out of bankruptcy. This is intensifying the problem.

The relief in 1041 is on target. There are some technical problems that I think should be dealt with, and I will submit comments, Senator, because I just acquired a copy of 1041 recently——

Senator BOREN. Right.

Dr. HARL [continuing]. I will submit a more detailed commentary on the technical side of that.

On the discharge of indebtedness, the second problem area, the general rule is that discharge of indebtedness is income. But there are four exceptions to that rule. One is if you are in bankruptcy. The second is if you are insolvent, not in bankruptcy. The third is for purchase price reduction, and the fourth is the solvent farm debtor rule.

I want to emphasize, Senator, that Chapter 12 bankruptcy debtors in my opinion are eligible for participation in the rule for debtors in bankruptcy. I think there has been some confusion about that in the country even among tax practitioners. In my opinion Chapter 12 debtors are in bankruptcy for that purpose.

Unfortunately, this only deals with the discharge of indebtedness aspect. It does not deal with the gain problem, which is the problem in the McLearan situation in Oklahoma. But the discharge of indebtedness rule is terribly important in all of this and I would point out that the relief provision in 1986 originally was drafted so that it did not result in taxable income for the debtor. But that was changed in the Technical and Miscellaneous Revenue Act of 1988, much to the surprise of a number of us because we thought that was somewhat beyond a technical correction. But it is there and we have to live with it.

There are two other aspects of that provision enacted in 1986 that are worthy of note. One is the lack of definition of gross annual receipts and the fear that this could lead to a loss of eligibility when you liquidate machinery and land, and then the fact that you have to be an institutional lender to be eligible.

The forgiving of principal could be summarized here to say that we have two rules, one for related parties and one for unrelated parties. The rule for related parties is inhibiting sellers from helping financially troubled buyers. We think that should be dealt with. I would favor a statutory solution. There is a private letter ruling that is discussed, Ltr. Rul. 8739045, but we do not believe that ruling addresses the problem adequately.

The fourth problem is abandonment, and this is a serious problem today in Chapter 7 bankruptcy and in Chapter 11 bankruptcy. The problem is the uncertainty as to who pays the income tax on assets that went into bankruptcy at the time of filing and were abandoned by the trustee because the value of the asset was less than what was owed on it. Two recent cases, both in the northern district of Iowa, have held that it leaves the debtor with the potential income tax liability. Those cases are cited and discussed there. I think that the entrapment theory is sound and I would urge that some attention be given to that approach because it is an integral part of this entire problem area.

Finally, and in my formal testimony this discussion appears toward the end of a discussion on the handling of abandonment, is the tax fate of Chapter 12 filers. This is a problem of great magnitude because, as my testimony shows, there has been widespread use made of Chapter 12. In fact, we have some statistics from in the north central region indicating that for those states as of the 31st of May of this year, there have been 4,558 filings in those 11 States. So it is a very widely used provision.

Unfortunately, at least unfortunately in my view, the Bankruptcy Tax Act of 1980 was never amended to include Chapter 12 filers. This has created immense uncertainty because one section of that 1980 legislation in fact undercut prior law that existed with respect to separate entity status and so filers could not even take refuge there. There is even uncertainty as to whether you can deduct the administrative costs of Chapter 12 bankruptcy. We think that the best solution is simply to include Chapter 12 either——

Senator **Boren**. Under the 1980 law?

Dr. **Harl**. Under the 1980 law—or at least provide an election to the taxpayer. If the taxpayer wants to keep it very simple it might be able not to have a separate entity, but would have at least the elective opportunity to utilize the same rules that Chapter 7 and 11 filers have. This has dogged Chapter 12 from the very beginning, and of course, it also precludes the fresh start that is possible under Chapters 7 and 11.

I think a very compelling case could be made for that to be done, and I think this would help the McLearan situation because they do not have that opportunity at the present time. I would add, however, that even if we had that, the problems of abandonment are such that wherever an asset is worth less than what is owed on it, there is the threat it will be returned to the debtor and you lose the fresh start that is assured otherwise.

So we see these as a package, Senator. We believe that Senate Bill 1041 with some changes in the technical side deals with the relinquishment problem with respect to gain, but we think there is more to the problem. In order to deal with it fully, we would suggest that a broad view be taken because there are people out there struggling daily with respect to all these problem areas.

Thank you so much.

[The prepared statement of Dr. Harl appears in the appendix.]

Senator **Boren**. So in addition to 1041, which with your technical modifications which we will certainly study, another step that needs to be taken is the modification of the Bankruptcy Act of 19——

Dr. **Harl**. Of 1980. Yes, sir.

Senator **Boren**. And then what else were you suggesting?

Dr. **Harl**. I would suggest amendment to Section 453B which would treat related and unrelated parties the same. As it is now, they are not treated the same and land values in your State you said had fallen——

Senator **Boren**. Yes.

Dr. **Harl** [continuing]. Fifty percent. In my state, fell 63 percent before starting to rise. Where land values have fallen, a seller does not want that land back.

Senator **Boren**. No.

Dr. **Harl**. And so the seller often is willing to forgive principal. In fact, it is better for the seller to forgive some principal and keep the buyer in place, than to have that land forfeited back to the seller. But if the seller has gain, the seller is inhibited from doing that, and indeed, the related party rule says you cannot avoid the tax because you must use the face value of the instrument as the fair-market value.

That is not the rule for unrelated parties. There you take the fair-market value of the contract, and if the land value has fallen, almost certainly the value of the contract has as well. So we think that, coupled with another amendment that would deal with who a financially-troubled buyer is, to relieve the seller from the risk of income tax liability from agreeing to a write down of that principal would be in accord with the Agricultural Credit Act of 1987. Only in this case you are dealing with private land contracts and not FmHA or Farm Credit System obligations. But this is an inhibiting factor. So we would suggest an amendment to Section 453B.

We also think there should be an amendment to Section 108(g) in two respects, to deal with the definition of gross receipts and also to deal with that very limiting lender rule that prevents any but a debtor with an institutional lender from participating in that very important relief legislation.

So we see several provisions that ought to be dealt with here.

Senator BOREN. Several additional items that will have to be dealt with.

Dr. HARL. As well as abandonment, which I think also should be addressed in the Bankruptcy Tax Act of 1980 and should be included in Section 1398 of the Code.

Senator BOREN. Thank you. Thank you very much.

Those are very, very helpful, concrete suggestions, and we will look at those very carefully in terms of drafting the final legislative remedy.

Mrs. Watkins, we are very happy to have you this morning and appreciate your joining us and look forward to hearing your comments this morning.

STATEMENT OF SHARON K. WATKINS, PUBLIC ACCOUNTANT, WATKINS TAX ACCOUNTING, TESTIFYING ON BEHALF OF THE NATIONAL FAMILY FARM COALITION, LEXINGTON, IN

Mrs. WATKINS. Thank you.

Thank you, Mr. Chairman and Senator Dole, for the opportunity to speak to you on the subject of Senate Bill 1041.

On behalf of the Credit Committee of the National Family Farm Coalition, representing over 40 organizations in 35 states, I would like to express our support for swift action by this Congress on the Farm Debt Tax Reform Act of 1989 and to thank you for your leadership on this most important issue.

My testimony today will focus on areas of concern that have been raised by farmers working with the Credit Committee since the bill's introduction.

As family farmers struggling to save our farming operations through the new debt restructuring options in the Agricultural Credit Act, we view this new legislation as a top priority to achieve the goal of enabling family farmers to stay on their farms and in their rural communities.

I am Sharon Watkins. I am a farmer, and an accountant from Southern Indiana. With my young son, I farm 500 acres. We raise corn, soybeans, tobacco, wheat, hay, and livestock. I also have an accounting practice. Besides doing over 100 farm tax returns each year, I assist farmers in restructuring their farm debts. Working either directly with the farmer or with attorneys, I prepare balance sheets, cash flows, other financial reports and restructuring plans as requested by the court or the creditors.

It is my opinion that passage of Senate Bill 1041 in 1989 is as important to farmers as the passage of the Agricultural Credit Act was in 1987. It was your leadership, Mr. Boren, in the Senate Credit Committee that helped to ensure that farmers received borrowers' rights through that legislation. Now, many of these same borrowers are not able to make the important decisions on their future due to uncertainty over under the tax consequences. We agree with the recent IRS ruling on the impact of shared appreciation agreements and the timing for tax liability. Yet we feel it should be incorporated into the statute so that farmers and their accountants are fully aware of its existence because now I think I may be the only person in Indiana that knows that letter exists.

Many farmers are now trying to restructure their debts with their lenders, especially with the Farm Credit System and Farmers Home Administration. This tax provision is critical for them, as well as those borrowers who are not able to continue farming and have no feasible plan of restructuring to present other than a sale or conveyance of all or part of their assets.

If they file a Chapter 11, again the question of feasibility would come up. But if they are liquidated, the Chapter 11 rules would help with the tax problem. The major drawback to a Chapter 11 is its cost of thousands of dollars, dollars that Senate Bill 1041 by avoiding bankruptcy for these farmers would make available to pay their creditors. Plus, many farmers would scale back their operations rather than do a complete liquidation if given the choice. But those choices are taken from them if they must file a Chapter 11 to avoid taxes they cannot pay. The court, the trustee, the bank, and their creditors take control of their operation in a Chapter 11.

Attached to this testimony for the record are tax returns using 1988 tax rates of a farmer who is considering conveying his property to his creditor.

[The information appears in the appendix.]

Mrs. Watkins. The difference in the tax liability as demonstrated by Exhibits 1 and 1A is $104,543 using the maximum amount of capital gain of $350,000. The question of whether he would be liable for taxes of $104,543 means the difference between this particular farmer being able to restructure his debts or file Chapter 11. He has a restructuring plan approved by the Farm Credit Service, which is his only creditor. The tax question is the only remaining issue to be resolved.

If this bill is enacted it would not reduce taxes, but it would delay the collecting of those taxes. In the above example, if this farmer chooses to file Chapter 11 bankruptcy, he would eventually be discharged from the bankruptcy, and according to his other assets, after he was, he would not owe any taxes. Maybe the estate of the bankruptcy would pay some taxes, but not a whole lot. Nor would he have his basis in his remaining real estate adjusted. When his real estate is eventually sold or considered in his estate at death, he would not owe more taxes because of his bankruptcy restructuring.

If this bill is enacted in its current form, he would owe more taxes if he chooses to use the provision of the law because of tax attributes being adjusted. Not only the basis in the real estate would be adjusted, but immediately the loss of the use of net operating losses and investment credits would result in more tax revenue being collected annually. We would urge this subcommittee to modify the order of the tax attributes to ensure that the legislation benefits those farmers who have been operating at a loss.

The best business decision for a farmer would be to file bankruptcy and not use 1041 in its current form. But I assure you, my experience with farmers is they would choose the provision of this bill rather than file bankruptcy. Most farmers would take any other option given to them before rather than choose bankruptcy.

Senate Bill 1041 does not result in lost revenues. It results in eventually collecting more taxes, plus costs less because fewer farmers would file bankruptcy. I have no idea what the cost to the government is for a farmer's bankruptcy, but the farmer's cost is $15,000 at a minimum. The cost to the government for maintaining courtrooms and salaries of judges, clerks, and trustees are certainly not covered by the $200 filing fee, and by giving farmers another option during restructuring, more money would be available for their creditors now.

I do have a concern about the definition of equity in the language of the bill. I would like to be assured equity in all property means total balance sheet net worth, even if this amount is negative. Attached as exhibit 2 is a balance sheet and an equity analysis of a farmer. The equity analysis is the accepted way I have always been instructed by attorneys and bankruptcy courts to prepare analyses, and the members of my panel agree with me that this is the correct way. Please note the difference between net worth and net equity in my example is $50,000. Using the equity analysis he is not eligible for this bill, but is under the net worth test.

Plus, most farmers with financial difficulties have found it necessary to finance their own operations and provide for a full year's family living expenses. This necessitates a farmer having a large inventory of cash or inventory at the end of harvest. Perhaps more than $25,000 maximum equity should be allowed, or there should be a different way to incorporate the family living expenses into that calculation.

Attached as exhibit 3 for the record are several balance sheets and a cash flow. My example, which I believe is typical of the majority of mid-west farmers, is of a row crop or grain farmer who does not have an off-farm job or raise livestock. Income is only once a year for fall harvest time. This finances the entire operation providing 1 year of family living expenses from the sale of the crop of the preceding year. Because a growing crop is valued at the lower of cost or market value and the consumption of the family living allowances, this farmer is eligible some of the time, but ineligible the balance of the year. His net worth and the date of that net worth are listed here and it ranges from $50,000 to a negative $3,337, the same farmer throughout the year.

My calculations show, and attached as exhibit 4, with a capital gain of up to approximately $59,500, a farmer would be allowed the maximum net equity of $25,000, and with a maximum capital gain of $350,000, a farmer would be allowed to have a net equity of approximately $147,000.

Experience would suggest most farmers would fall in the lower range, and as the above example shows, it would depend on the timing of the sale or conveyance as to whether many farmers would be eligible to use the provisions. Most farmers and creditors would not consider the timing or would not have enough control of the events surrounding the sale or conveyance to time events at the optimum time.

Following are some additional areas that we feel need to be closely examined by this committee and hopefully included in the final legislation. They relate to the farmer definition in the legislation. We want to be sure that farmers who went through debt settlement during the period of the *Coleman* injunction, at which time FmHA interpreted the injunction to mean they could not finalize debt settlements, are able to benefit from these provisions of capital gains exclusion.

The farmer definition requires that 50 percent of the gross receipts have been from farming for 6 of the past 10 years. While this may help some of the borrowers in 1989, we are concerned that it may be an unintentional barrier for farmers 10 years from now. We support a provision in the bill that would specifically address farmers affected during this recent time frame. In addition, we support changing the material participation test to the qualified farm indebtedness section, removing it from the farmer definition.

Thank you for allowing me the opportunity to comment on this bill. We look forward to working with you to ensure swift passage of this important legislation. This is an important step towards meeting the goals of the Ag Credit Act for many farmers. It will help farmers stay on their farms and small businesses remain, such as our implement dealers, which directly strengthens our rural communities.

If I may answer any questions, I would be happy to do so.

[The prepared statement of Mrs. Watkins appears in the appendix.]

Senator BOREN. Thank you very, very much.

The testimony of all of you has been very, very helpful to the committee this morning because you have not only helped us define the problem and amplify the problem and made it more real and concrete to us, but you have also given us some very excellent suggestions on how to proceed.

I am certainly going to make an effort—I know Senator Dole is and other members of the committee—when we do consider tax legislation this year and the tax and budgetary package through the reconciliation process to get some legislative language attached to deal with this problem because I know how urgent it is. We are going to do everything that we can to be successful in this area and having these concrete suggestions from you is very, very helpful.

Let me turn to my colleague, Senator Dole, now for any comments he might like to make, and Senator Dole, we really appreciate you being with us this morning.

OPENING STATEMENT OF HON. ROBERT DOLE, A U.S. SENATOR FROM KANSAS

Senator DOLE. First I want to thank you, Mr. Chairman, for conducting these hearings and for your leadership in all areas of agricultural taxation, and this is certainly an important one.

I do not know how this situation arose in the first place. We have not figured it out yet. Sometimes you do not know whether the government is working for you or not. I have listened with interest to the statements. I listened with particular interest, Dr. Harl, to your statement. I think it does have a number of good, specific suggestions that we might be able to incorporate.

And also, Mrs. McLearan, I think there is a time deadline here if we do not do something this year—you are going to have to get another extension as I understand it.

Mrs. McLEARAN. We cannot get another extension.

Senator DOLE. You cannot get another extension?

Mrs. McLEARAN. We are up October 15.

Senator BOREN. They are against October 15. We may need to——

Senator DOLE. We will have to move fairly quickly.

Senator BOREN. We may need to contact the IRS to get——

Senator DOLE. I am going to be seeing Secretary Brady at 11:30. I will hand him a copy of your testimony. I will be happy to do that and let him know of Senator Boren's interest and that will frighten him a little. [Laughter.]

Mr. Chairman, I think I will just put my statement in the record. You have certainly covered everything. We do want to correct this situation and make some other corrections. I think Senator Boren is right on target. I am pleased that my colleague, Senator Kassebaum, was here earlier because this matter should be corrected, should be done very quickly, and I would be happy to work with Senator Boren to see if we cannot expedite this. Our problem may be finding a vehicle——

Senator BOREN. The vehicle.

Senator DOLE [continuing]. Because revenue bills originate in the House, and I am not certain we have any over here now.

Senator BOREN. I guess we are waiting for them to send us one or——

Senator DOLE. Or maybe we could put it in reconciliation.

Senator BOREN [continuing]. Put it in reconciliation.

Senator DOLE. Put it in reconciliation, and hopefully that would be completed by October 15, but there ought to be some way we could address that particular problem.

Mrs. McLEARAN. I hope so.

Senator BOREN. Maybe we could get the Department and the Service to give a blanket extension for a little longer period, knowing that we are working on the legislative remedy. Maybe we could get them to carry us, at least, through the end of this session to give us time to act on it.

Senator DOLE. And I am pleased that Chapter 12 is being used so widely. Many members worked very diligently on it, including Senator Grassley as you know. I do not know whether it was his original idea, but he certainly was one of the key sponsors of that legislation. And I do not think anybody ever thought it was going to trigger tax liability if you have debt forgiveness. It probably would not have been used at all because of the very things you have each spelled out.

Senator BOREN. Right.

Senator DOLE. So I just say to the panel and to Senator Boren, I am certainly pleased to be here and certainly want to be helpful and I would ask that my statement be made a part of the record.

[The prepared statement of Senator Dole appears in the appendix.]

Senator **Boren**. Thank you very much.

Let me just ask because, after I said we would not ask after each person, I did end up asking questions after each one, so I have pretty well covered most of the things that I wanted to ask, and we will go back. We have our own technical experts on the staff, tax experts, to go into the specific suggestions that you have made and also that you have brought with you. For example, Mrs. McLearan from your own tax counsel, the letters that we are going to receive.

Mrs. **McLearan**. Mr. Chairman, I would like also to ask that my cover letter be admitted as written, along with the examples from tax attorney.

Senator **Boren**. Absolutely. We will certainly do that.

Mrs. **McLearan**. Thank you.

Senator **Dole**. I am writing a little note to Secretary Brady on your testimony and I will give it to him in about 10 minutes.

Mrs. **McLearan**. Thank you.

Senator **Boren**. Excuse us. We are working on the disaster bill here at the same time. He is on his way to see—this is the way work gets done around here. We all stay so busy that when we finally do get to see each other, why, we have to take advantage of the opportunity. So we are working on the drought bill a little bit and also getting this note ready to take over to Secretary Brady on your situation.

Mrs. **McLearan**. Thank you.

Senator **Dole**. I was on WHO the other day and I said, "How's the corn crop?" They said, "We're worried about a frost. Everything else looks so good." Now we are worried about the frost. [Laughter.]

I understand that is not true in North Dakota though.

Ms. **Vogel**. In North Dakota we have had very little relief since July 4th weekend when everything really went to pieces.

Senator **Dole**. Which Senator Conrad has pointed out.

Senator **Boren**. It has gotten so much worse since then.

Ms. **Vogel**. And it is still hot and it is still windy and it is very severe. I have numbers and all that with me in case anybody wants to see them.

Senator **Dole**. I would like to have those if you give those to Carolyn after——

Ms. **Vogel**. Yes, yes.

Senator **Boren**. Because we are working on trying to get the Disaster Relief Bill, get an agreement on it and get up on the floor next week, get it all wrapped up before we go out, so we have two or three emergencies here we are trying to deal with at once and trying to get them done.

We will be right back with you, if you could just hold for one second.

Let me just ask the point on tax attributes, for example, the carrying forward of the net operating losses, not being able to carry those forward as the bill is now written.

Do all of you view that as a potentially serious problem? I know Mrs. McLearan spoke about that. Do the rest of you see that as a potentially difficult problem as well?

Dr. **Harl**. I think it is, Senator. I think that this bill probably should track Section 108 in terms of tax attributes. I think it should be not less advantageous to taxpayers than the Section 108 provisions already are. Practitioners are familiar with that regimen, and I would be more comfortable, I think, with that approach with the relief provision preceding the reduction of tax attributes under Section 108.

Senator **Boren**. Fine.

Ms. Vogel, do you agree with that, and you, Mrs. Watkins? It does seem to me that, you know, here we are. It is sort of cruel and unusual punishment again to get people on a path where they might be able to work their way out of it and then put them in a situation where they are never going to be able to get the cash flow to really meet their debts because of what we are doing to them in the tax consequences. As long as we are limiting this to people in financial distress, there are not others that are going to come in and get a windfall out of it.

Well, as I say, I have rarely seen testimony that is going to be more helpful to us as we work on this than we have had today, as we work on the specifics of this, because you have all had excellent suggestions.

I really do not have any other questions. I think I understand your testimony. It is full and complete, and needless to say, I agree with it. I am struck by the urgency of the need to deal with it, and I assure you will have allies in this like Senator Dole and other members of this committee. We will be hounding our fellow members until we get some action on this. Our problem simply is, as he has stated it, that the Senate cannot move tax legislation on its own. We have to wait until there is a tax bill that comes over from the House to which we can attach this, and I would urge you to also be talking about, those in the House of Representatives that you know, urging them to get some sort of tax vehicle moving, either to pass this kind of legislation as a free-standing bill and send it over to us, or to get some other legislation.

We have been known to latch onto any tax bill that moves and add significant amendments over here. I remember the one famous bill that dealt with the tax exemption on taxes on a church bell that ended up being a major rewrite of the entire tax code after the amendments were added. So we just simply have to find a vehicle and that is going to be our problem, finding the vehicle to which we can legally attach a tax amendment over here in time to get this problem dealt with as the clock is running against us, but we will do our very best to do that.

Senator Dole has told me that he is going to discuss this with Secretary of Treasury Brady this morning in his meeting with him, and you certainly have been a great help to us in making the long trip to be here and to testify with us this morning, and I will assure you that your testimony is going to have more impact than might appear from the members of the committee who heard you in person this morning because it gives us a good blueprint to work from as we are redrafting the legislation.

I think that Senator Conrad and I and others who introduced the bill realized it was not the total solution, but again, we wanted to get a vehicle introduced as soon as possible to enable us to begin to draw attention to this problem, and another requirement we have in the Senate very generally is that you cannot act on legislation on the floor until we have had a hearing in the appropriate committee on the legislation. So even if we were act to use it as a floor amendment or a committee amendment either one, it is very necessary for us to have a hearing and to have this kind of information in the record. So you have helped us very significantly by being here this morning and moving the process forward and we will be doing all that we can.

Thank you for joining us this morning. Thank you very much.

Ms. **Vogel**. Thank you.

Mrs. **McLearan**. Thank you.

Dr. **Harl**. Thank you.

[Whereupon at 11:20 a.m., the hearing was concluded.]

APPENDIX

ALPHABETICAL LISTING AND MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR DAVID L. BOREN

We are here today to discuss a number of very serious problems facing America's family farmers. As a member of the Agriculture Committee and a past chairman of the Farm Credit Subcommittee, I am very much aware of the financial burdens our farmers are currently facing. In an attempt to address some of those problems the Agricultural Credit Subcommittee wrote a broad restructuring of the Farm Credit System in 1987. It was our intention then to help America's farmers avoid bankruptcy by allowing them, and the various financial institutions, the flexibility to restructure their enormous debt when it was less costly to the taxpayer to do so. The Agricultural Credit Act of 1987 helped stop the vicious cycle we were experiencing where declining farmland values led to more foreclosures, more land sales, and therefore still lower land values. But there is work yet to be done.

Today a farmer seeking to avail him or herself of the various means of restructuring their debt may yet find themselves facing an insurmountable tax liability. Typically in the past when a farmer sought to restructure, and the lender was willing to discharge certain debts, any discharged debt over than the amount of the farmer's "basis" in the property and his "tax attributes" was treated as non-taxable income.

Today, as a result of a "non-controversial" technical amendment in last year's tax bill, a farmer who seeks to restructure his debt is likely to find himself facing a tremendous tax liability on "phantom" income he never received. Current law limits a farmers ability to exclude from taxable income discharged debt only to the extent he reduces his basis and uses his tax attributes. Now the farmer must treat as taxable income any amount of discharged debt in excess of basis and tax attributes. He now must pay tax on money he never had!

It would appear our efforts to help our family farmers avoid bankruptcy have been substantially negated. Can a farmer now seek shelter in Chapter 12 bankruptcy and have the debt discharged under a court approved restructuring plan? Will that allow the forgiven debt to be treated as non-taxable "income?" Evidently not in Oklahoma, where several of my constituents have been informed by the IRS that Chapter 12 or not they are being held liable for taxes on "income" they have never seen.

Some agricultural producers and tax specialists suggest a return to the provision in the 1986 tax reform is not enough. Even under that provision a farmer had to give up his tax attributes first.

Clearly these are problems that need that to be addressed and hopefully today we can come up with some answers. One of the proposed solutions is legislation (S. 1041) that would provide not only an exclusion of discharge of indebtedness income for farmers, but also provide an exclusion for capital gains that arise when farm property is transferred to a lender in exchange for debt relief.

This issue is certainly a timely one. After a FmHA moratorium of several years and the implementation of the Agricultural Credit Act, thousands of farmers are now completing the restructuring process. Also, FmHA is preparing to send out the next wave of delinquency notices soon. Many borrowers who restructured their loans this year are confused about the rules that apply to them, and those who will soon receive notices will need to be sure of the tax consequences of their options before a sound decision can be made. However, it is important to note that this problem applies to more that just those borrowers restructuring under the Ag Credit Act.

I look forward to hearing the suggestions and comments from my colleagues and our panelists who have no doubt traveled great distances to be with us today.

Attachment.

DESCRIPTION OF S. 1041 RELATING TO CAPITAL GAIN ON TRANSFER OF FARM PROPERTY IN DISCHARGE OF CERTAIN FARM INDEBTEDNESS

(Prepared by the Staff of the Joint Committee on Taxation, July 21, 1989, JCX-36-89)

INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled a public hearing on July 28, 1989, on S. 1041 (introduced by Senators Conrad, Daschle, Boren, and others). The bill would provide tax relief for certain farmers who realize gain on the transfer of farm property in satisfaction of farm indebtedness. In addition, the bill provides that farmers meeting certain requirements could exclude income from discharge of farm indebtedness, subject to a maximum dollar limit.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the provisions of the bill, including present law and effective dates.

PRESENT LAW AND BACKGROUND

Gain on transfer of property for cancellation of indebtedness

Gain from the sale or other disposition of property is determined by computing the excess of the amount realized therefrom over the adjusted basis of the property. The amount realized is the sum of any money received plus the fair market value of any property (other than money) received. In general, the entire amount of gain determined on the sale or exchange of property is recognized for Federal income tax purposes (sec. 1001)

If a taxpayer transfers property to a creditor in exchange for the cancellation of an indebtedness, the taxpayer may recognize both gain on the property and cancellation of indebtedness income. The transfer of property in consideration of the cancellation of indebtedness is equivalent to a sale for Federal income tax purposes. For example, if the debt that is cancelled is one for which the taxpayer is personally liable, gain will be recognized in the amount of the excess of the fair market value of the property over the basis of the property. In addition, the taxpayer will have discharge of indebtedness income in an amount equal to the excess of the amount of the debt discharged over the fair market value of the property.

Cancellation of indebtedness income

Gross income generally includes income from the discharge of indebtedness (sec. 61(a)(12)).

Treatment of insolvent taxpayer

If an insolvent taxpayer realizes income from discharge of indebtedness, the income is excluded and certain tax attributes of the taxpayer (including items such as net operating loss carryovers and basis in property) generally are reduced by the excluded amount. The exclusion is limited to the amount by which the taxpayer is insolvent. If the taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds these tax attributes, the excess is forgiven, i.e., is not includible in income (sec. 108).

Treatment of certain farm indebtedness

The Tax Reform Act of 1986 provided that, in the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," the discharge is treated in a manner similar to a discharge incurred by an insolvent taxpayer (sec. 108(g)). Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a specified gross receipts test. The gross receipts test is satisfied if 50 percent or more of the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which the discharged indebtedness occurs is attributable to the trade or business of farming. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements. The Technical and Miscellaneous Revenue Act of 1988 provided that the amount excluded under this provision generally may not exceed the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in property held for use in a trade or business or for the production of income. Thus, if there is any remaining discharge of indebtedness income after the taxpayer has reduced these tax attributes, income will be recognized.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of S. 1041, Relating to Capital Gain on Transfer of Farm Property in Discharge of Certain Farm Indebtedness* (JCX-36-89), July 21, 1989.

EXPLANATION OF THE BILL

In general

S. 1041 (introduced by Senators Conrad, Daschle, Boren, Harkin, Kerrey, Dixon and Burdick on May 18, 1989) would provide tax relief for certain farmers who realize gain on the transfer of farm property in satisfaction of farm indebtedness. In addition, the bill provides that farmers meeting certain requirements could exclude income from discharge of farm indebtedness, subject to a maximum dollar limit.

Exclusion of certain gains

The bill would exclude from the gross income of certain farmers that portion of the gain from the transfer of farm property in complete or partial satisfaction of qualified farm indebtedness (i.e., debt incurred directly in connection with the trade or business of farming) that does not exceed $350,000. This rule would apply to a taxpayer that meets all of the following requirements: (1) the taxpayer's adjusted gross income (with certain modifications) is less than the national median adjusted gross income; (2) more than 50 percent of the taxpayer's gross receipts for 6 of the 10 taxable years preceding the year of transfer is attributable to the farming business, the sale or lease of assets used in farming, or both; (3) the taxpayer materially participates in the farming business; and (4) the amount of equity in all property held by the taxpayer after the transfer is less than the greater of (a) $25,000 or (b) 150 percent of the excess of the tax that would be due if this provision and section 108 of the Internal Revenue Code (which relates to exclusions of certain discharge of indebtedness income) did not apply, over the tax that would be due if this provision and section 108 did apply.

The bill provides that the $350,000 limit on excludable gains would be reduced by prior year exclusions of gains under this provision, as well as by current year and certain prior year exclusions of discharge of indebtedness income under section 108. In addition, any amount that is excluded by reason of this provision would reduce certain tax attributes of the taxpayer.

Exclusion of discharge of indebtedness income

The bill provides that farmers meeting certain requirements could exclude income from discharge of qualified farm indebtedness, but not in excess of $350,000. This provision would apply to a taxpayer meeting the requirements described above if, in addition: (1) the taxpayer's indebtedness both before and after the discharge is equal to 70 percent or more of the equity in all property held by the taxpayer, and (2) the taxpayer transfers only farm property to discharge the qualified farm indebtedness.

The bill provides that the $350,000 limit would be reduced by prior year exclusions of gains from the transfer of farm property (under the provision described above) and prior year exclusions of discharge of qualified farm indebtedness income under this provision.

The present-law rule that generally limits the exclusion of income from the discharge of qualified farm indebtedness to the sum of the taxpayer's loss and credit carryovers and the taxpayer's basis in certain property, would not be changed by this provision of the bill.

EFFECTIVE DATES

The gain exclusion provision of the bill would apply to transfers after December 31, 1986, in taxable years ending after such date. The provision of the bill relating to the exclusion of discharge of indebtedness income would apply to discharges of indebtedness occurring after December 31, 1986 in taxable years ending after such date.

PREPARED STATEMENT OF SENATOR TOM DASCHLE

I am pleased that Senator Boren, as Chairman of the Subcommittee on Energy and Agricultural Taxation, decided to hold this hearing on the grave tax consequences faced by farmers who undergo debt restructuring. I have been working on these problems with Senator Conrad since last year, and I want to express my appreciation to Senator Boren for this opportunity to study them in more detail.

Subsequent to the passage of the Agricultural Credit Act of 1987, which permitted marginally insolvent farmers the option of having their debt restructured, I and many of my colleagues began receiving letters from farmers telling us that, in many cases, the tax consequences of debt restructuring were placing farmers in a worse position than if they had not undergone restructuring at all. At the end of last year, Senator Conrad and I introduced legislation to address the tax problems associated with debt restructuring.

We sought and received extensive comments on the bill we introduced last year and used these in an attempt to improve our measure, which we reintroduced this year with Mr. Boren and several other members of the Senate. I think our bill has been substantially improved, but I want to state for the record that it is not set in stone. We welcome further suggestions for enhancing its provisions.

It is hard to underestimate the dimensions of this issue. The decline in the agricultural economy continues. Last year, we lost over 1,000 farms in my state of South Dakota alone. More and more farmers are falling behind on their debt payments and are seeking ways to get back on their feet again. This year, over 15,000 delinquent farm borrowers nationwide will be notified of their right to restructure their debt.

I am sure that all the technical details of the tax effect of debt restructuring will be covered at this hearing. A major part of the problem revolves around the recognition of capital gain, particularly where the farmer sells property in order to retire debt. I just want to emphasize that this aspect of the problem is exacerbated by the repeal of the capital gains exclusion in the Tax Reform Act of 1986. Since that major overhaul of the tax code was passed, capital gains have been taxed at a higher effective rate. This, along with the elimination of a number of other tax provisions that were beneficial to farmers, has increased the financial burdens on farmers facing debt problems.

In closing, let me point out that the bill introduced by Senators Conrad, Boren and I does not open a giant loophole for farmers. It incorporates a number of safeguards that will insure that it can only be used by those for whom it was intended. More importantly, it furthers the intent of Congress in passing the Agricultural Credit Act of 1987.

I am hopeful that my colleagues in the Senate, who will read the transcript of this hearing, will take the matters discussed here to heart and assist me and the other sponsors of this important legislation in getting it passed as soon as possible.

Thank you.

PREPARED STATEMENT OF SENATOR BOB DOLE

Mr. Chairman and distinguished finance committee colleagues, I know you are concerned about the debt burdens that threaten not only many thousands of farm families, but also their communities and their way of life.

Soaring farmland values in the 1970s encouraged farmers to borrow amounts which now exceed the value of their assets. As these families struggle against insolvency, each new crisis, such as another year of drought, jeopardizes their ability to both service those debts and meet current expenses.

In 1986, the Congress enacted two laws which addressed this problem directly. First, it created an expedited farm bankruptcy procedure, Chapter 12, to provide relief to farm families with overwhelming debts. Chapter 12 allows small farmers to set up a three-year payment schedule for their obligations and to obtain a discharge from the excess unsecured debt. Of course, a Chapter 12 discharge, like any discharge in bankruptcy, does not trigger income tax liability on account of the forgiveness of indebtedness.

However, while providing needed relief to debtor families, a Chapter 12 discharge may increase the suffering within their communities. This is because a bankruptcy proceeding will adversely affect every unsecured creditor. Generally, those creditors will include the local feed lot, the grocer, the hardware store and other small businesses which may be as unable to do without future debt payments as the family was to make them.

Accordingly, with the support of Senators Kassebaum, Grassley and many members of this subcommittee and of the Finance Committee, I included an amendment in the Tax Reform Act of 1986 to provide that the discharge of qualified farm indebtedness outside of bankruptcy, like its discharge under Chapter 12, would not trigger income tax liability on account of the debt forgiveness.

Our amendment was specifically designed to provide an alternative debt relief procedure that would protect the local businessman. It enabled a farmer to secure a private restructuring of his debt to one or two major creditors and thereby avoid bankruptcy. Without this amendment, these private restructurings, which benefit the community, would actually penalize the debtor by creating a new tax debt, often many thousands of dollars worth, which would undo the very relief he needed.

Unfortunately, two years after its enactment, and two years after many farmers had restructured their debts in reliance on this relief, our amendment was retroactively undone by a 1988 technical correction. This very untechnical technical was not discussed with me or with my staff. Moreover, because it so clearly defeats the specific purpose of our amendment, I am convinced that a mistake was made.

Accordingly, I have written to my good friend, the distinguished chairman of the Finance Committee, requesting that this error be corrected in a further technical correction. Failure to redress this wrong will have adverse consequences for farm communities in my State and in his. But most unfairly, it will impose a retroactive and undischargeable tax burden on those farmers who sought the private debt relief—which I believe was the best solution then available—at a time when that relief was tax-free.

I pledge to work with this subcommittee to ensure that this injustice does not occur.

Prepared Statement of Neil E. Harl

Experience of the past five years with unsustainable debt in agriculture has identified five major tax problems. Those problem areas are (1) substantial amounts of gain on relinquishing property to creditors or otherwise, even by insolvent debtors; (2) handling discharge of indebtedness income; (3) gain to sellers of property on contract who forgive principal to assist a financially troubled buyer; (4) gain on abandonment of property in bankruptcy; (5) the uncertainties of income tax treatment of debtors in Chapter 12 bankruptcy.

I. GAIN ON RELINQUISHING PROPERTY

A problem that has grown increasingly severe as the farm debt crisis has deepened is the triggering of gain on the transfer of property to satisfy debt. Initially, many of the assets sold or turned over to creditors had a relatively high income tax basis and produced little, if any, gain. As the debt problems have persisted, a rising proportion of assets relinquished to satisfy debt have had a low basis. The result, in many instances. has been an astonishing amount of gain. The gain is taxable *even though the debtor is insolvent.*

For recourse debt, the turnover of property to creditors produces gain or loss measured by the difference between the income tax basis of the property and its fair market value.[1] The difference between fair market value and the amount of debt discharged (not counting debt that would have produced an income tax deduction had it been paid) is discharge of indebtedness income.[2] For non recourse debt, fair market value is ignored and the entire difference between basis and amount of debt discharged is gain or loss on disposition of the property.[3]

A carefully limited provision forgiving gain on disposition of property to satisfy debt would be in accord with the concept of a "fresh start," the provisions on handling the discharge of indebtedness for insolvent debtors and those in bankruptcy [4] and the enactment in 1986 reducing the long-term capital gains exclusion as an alternative minimum tax preference item for the transfer of farmland by an insolvent farmer to a creditor in cancellation of indebtedness (or the sale or exchange of farmland under threat of foreclosure).[5]

II. DISCHARGE OF INDEBTEDNESS

As a general rule, all discharge of indebtedness produces income.[6] Four exceptions are recognized—(1) debtors in bankruptcy. (2) insolvent debtors not in bankruptcy, (3) solvent farm debtors, and (4) purchasers undergoing purchase price adjustment as to purchased assets.[7] It should be noted that even Chapter 12 debtors are eligible for the relief provision for debtors in bankruptcy.[8]

For farm debtors, the rule for solvent farm debtors enacted in 1986 has been helpful and would have been more so had the provision not been so limiting.[9] The most troublesome aspects of the provision include—(1) disqualification of obligations for relief involving noninstitutional lenders [10] and (2) the lack of definition for "gross annual receipts" and the concern that sale of assets to satisfy debt would disqualify debtors from using the provision.[11] An amendment was added in 1988 specifying that discharge of indebtedness in excess of tax attributes and reduction of basis is income.[12]

III. FORGIVING PRINCIPAL

If a seller of assets under installment reporting of gain cancels or forgives principal to help a financially troubled buyer, the forgiven or cancelled principal amount may have to be reported for income tax purposes as though the seller had collected the amount. I.R.C. § 453B(f), on its face, seemingly requires that outcome.

Under that statute, enacted as part of the Installment Sales Revision Act of 1980, cancellation or forgiveness of principal is treated as a disposition of the obligation. Thus, if the seller forgives or cancels the obligation to pay amounts due, the result is the same as a disposition of the obligation. If the seller and buyer are unrelated, the gain on cancellation or forgiveness is calculated using the fair market value of the installment obligation.[13] With one significant exception, the fair market value of the obligation should parallel the fair market value of the collateral. Hence, if land values have declined, so too has the fair market value of the installment contract or contract for deed. Indeed, if land values have fallen to the level of the seller's income tax basis in the obligation. there is no gain on disposition of the obligation. The exception is where the buyer has ample non-exempt assets reachable by creditors to satisfy a deficiency judgment. In that event, the fair market value of the installment obligation may be its face value.

In the event the seller and buyer are related, the calculation of gain on cancellation or forgiveness must use the face value of the obligation, not its fair market value.[14] Therefore, the more serious problem of gain on cancellation or forgiveness of principal is where the seller and buyer are related.[15]

The reason for the 1980 amendment cracking down on cancellation or forgiveness of principal was the practice that intensified during the 1970s of selling property to children, qualifying the transaction for installment reporting and then canceling payment obligations. often at Christmas time. The belief had emerged that the potential gain in the cancelled payments did not have to be reported for income tax purposes. The resulting legislation required that cancelled or forgiven payments had to be reported into income by the seller.

The question is whether the 1980 amendments apply to cancellation or forgiveness of principal to help a financially troubled buyer. The statute does not draw a distinction between financially healthy and financially troubled buyers. And the statute arguably is broad enough to encompass all types of cancellation or forgiveness of principal.

In the only formal pronouncement to date, in a private letter ruling, the Internal Revenue Service has indicated that cancellation or forgiveness of principal for a financially troubled buyer does not result in income to the seller under I.R.C. § 453B. The problem is that the ruling [16] cites to revenue rulings issued in the 1950s [17] and 1960s [18] and completely ignores the enactment of I.R.C. § 453B in 1980.[19]

Despite more recent informal statements that the Service does not intend to pursue the matter with sellers forgiving principal to help financially troubled buyers, a definitive statement by the Service or a statutory amendment is needed to lay to rest the residue of concern persisting in this area. The Congress is urged to eliminate the distinction between related and unrelated taxpayers.

IV. ABANDONMENT IN BANKRUPTCY

Stripped to its barest essentials, bankruptcy is a concept for—(1) providing honest but poor debtors a "fresh start" in their financial life and (2) assuring a fair distribution of property as among the unsecured creditors. Secured creditors are assured, of course, of receiving the value of their collateral.

Whenever the fair market value of a debtor's asset is less than the amount owed on the asset, the unsecured creditors gain nothing and there is no good reason for the bankruptcy trustee to spend time and money administering that property. The usual procedure is for the trustee to "abandon" the property.[20] That's typically done whenever particular items of property are "burdensome to the bankruptcy estate or of inconsequential value and benefit to the estate." Freely translated, that means there's nothing for the unsecured creditors.

Meaning of abandonment

Section 554 of the Bankruptcy Code recognizes four abandonment possibilities—(1) after notice and a hearing, the trustee in bankruptcy may abandon property that meets the test; (2) on the request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is of no benefit to the bankruptcy estate; (3) scheduled property not administered before a bankruptcy case is closed is deemed abandoned to the debtor and is considered to have been administered; and (4) unless the court orders otherwise, property of the estate that is not abandoned and that is not administered in the case remains property of the estate. Abandonment of property in farm bankruptcies has become quite common in many districts since the mid-1980s.

The pressing question with abandonments in recent years has been the income tax consequences.

The Bankruptcy Tax Act

Unfortunately, the Bankruptcy Tax Act of 1980, although providing highly useful guidance in handling some bankruptcy tax matter, failed to deal with the tax consequences of abandonment. Here's what we know—

- The movement of the debtor's property into the bankruptcy estate (for individuals filing under Chapter 7 or 11 bankruptcy) does not trigger adverse tax consequences.[21] A recent bankruptcy court case in opposition to that statutory provision, *In re Rasmussen,*[22] involves the highly novel theory that the property transfer upon bankruptcy filing involves a "sale or exchange." Apparently. *Rasmussen* was not appealed.[23]

Indeed, the statute makes it clear that a transfer of an asset from the debtor to the bankruptcy estate is not to be treated as a disposition "for purposes *of any provision of this title* . . . and the estate shall be treated as the debtor would be treated with respect to such asset." [24] Thus, not only should there be no gain or loss triggered on bankruptcy filing, there should be no recapture of depreciation or investment tax credit, no recapture of soil and water conservation or land clearing expense and no recapture of government cost sharing payments. Moreover, because of reference to "this title," there should be no recapture of special use valuation benefits and no acceleration of payment of Federal estate tax deferred under the installment payment options.

This provision assures that movement of assets into the bankruptcy estate should not trigger adverse tax consequences to he debtor.

- In a similar manner, the movement of assets (that survive bankruptcy) from the bankruptcy estate back to the debtor at the "termination of the estate" does not trigger adverse tax consequences.[25] Again, the debtor is treated as the bankruptcy estate would be treated with respect to the asset and the transfer is "not . . . treated as a disposition."
- If property of the bankruptcy estate is sold or disposed of in a taxable exchange to third parties (for example, stored grain sold at the local elevator) the usual non-bankruptcy rules govern the transaction. Gain or loss is recognized on the exchange.
- Nothing is said in the Internal Revenue Code about the tax consequences of abandonments in bankruptcy. As is nearly always the case where there is no statutory guidance in a tax matter, the courts struggle for coherence and uniformity.

Possible theories

Several years ago, two theories were identified as to the tax consequences of abandonment.[26] One theory, the *entrapment* theory, was premised on the assumption that abandoned assets had entered the bankruptcy estate without adverse tax consequences, in accordance with I.R.C. § 1398(f)(1), and that later abandonment from the bankruptcy estate triggered the usual tax consequences of a sale or exchange.[27] Any gain or loss and any recapture consequences would be the concern of the bankruptcy estate as a separate taxpayer. The debtor would take over the property with an income tax basis equal to its value so there would be no gain or loss to the debtor when the creditor exercised available remedies to acquire the property in satisfaction of the debt after abandonment.

The other theory, termed the *deflection* theory, assumed the abandoned property never entered the bankruptcy estate. Language in *Mason* v. *Commissioner* [28] and *In re Cruseturner* [29] supports the view that abandoned property is treated as if bankruptcy had not been filed. Rather, the property was deflected back to the debtor. Upon foreclosure or the exercise of other creditor remedies, the debtor faces recognition of gain or loss and the full range of recapture consequence. Both theories were discussed in detail in a 1988 article by Nelson.[30]

The differing outcomes from application of the two theories can be illustrated by the following example.

> Example: A farmer files Chapter 7 bankruptcy owning only a bin of shelled corn valued at $60,000. The local bank has a security interest in the bin of corn for $75,000. Thus, more is owed on the corn than the corn as collateral would bring in a sale of the corn at the local elevator. The trustee abandons the bin of

> shelled corn back to the debtor. The question is who pays income tax on the $60,000 of gain triggered when the local bank satisfies the security interest by possessing and selling the corn. With the entrapment theory, the bankruptcy estate has $60,000 of ordinary income on abandonment. With the deflection theory, the debtor has $60,000 of ordinary income when the corn as collateral is taken over by the bank.

The debtor's tax burden under the deflection theory may be even greater in some instances because of the position taken by the Internal Revenue Service that because of the discharge of the debtor's personal liability in bankruptcy, the debt survives abandonment as a nonrecourse obligation.[31] That result is consistent with *Commissioner* v. *Tufts.*[32]

The outcome is that the fair market value of the property becomes irrelevant and the full difference between the debtor's basis in the property and the amount of the debt is gain (or loss) to the debtor. In the above example, the debtor would have $75,000 of ordinary income, rather than $60,000.

Attempts to resolve

In January of 1985, an effort was made to interest IRS, the Department of the Treasury and the Joint Committee on Taxation in seeking solutions to the problem, but to no avail. In June of 1986, the Iowa State Bar Association and the Illinois Bar Association forwarded a joint resolution to IRS asking that the problem be resolved. Reportedly, a rulings project was created and repeated assurances were given that IRS was proceeding with a ruling with informal indications that the service would embrace the "entrapment' theory. By mid 1987, it became apparent that no ruling would be forthcoming and the matter reportedly was turned over to the Congress for solution.

The cases

Three bankruptcy court cases have addressed the question of the tax consequences of abandonment.

- In *Matter of Bentley,*[33] the bankruptcy trustee in 1986 had abandoned to the debtor the *proceeds* of a 1983 sale of corn by the bankruptcy estate. The 1983 sale was free and clear of liens with the understanding that the Commodity Credit Corporation (CCC) interest, if any, would attach to the proceeds and interest earned on the proceeds. In 1986, the trustee determined that the CCC claims were valid and exceeded the value of the crop. Accordingly, the trustee applied to abandon the proceeds. IRS argued that had the corn been abandoned prior to sale, the gain would not have accrued to the bankruptcy estate. But once the trustee sold the grain, the estate should be liable for the income tax on the proceeds. The bankruptcy court stated—

> The effect of the IRS position would have the estate pay taxes on property to which the estate is not entitled, did not retain and from which it received no benefit (because it was all abandoned) because the proceeds became property of the estate while subject to a lien which greatly exceeded its value. Such a result will not be countenanced.[34]

The case was reversed on appeal to the U.S. District Court.[35]

- The second case, *In re David Roger McGowan,*[36] involved abandonment of farm machinery and equipment valued at $58,614. The trustee reported the gain on the bankruptcy estate's income tax return. The Iowa Department of Revenue objected and was eventually joined by IRS with both agencies taking the position that the debtor was responsible for the tax. Initially, the IRS position was that the tax was the bankruptcy estate's responsibility.

The bankruptcy court held that the abandonment of the property by the trustee was not a "sale or exchange" that would trigger tax liabilities chargeable to the bankruptcy estate. The court reached its conclusion by convincing itself that "termination of the estate" [37] could be stretched to cover abandonments. Thus, the court seemed to be taking the position that the property enters the bankruptcy estate, conceptually, and then is abandoned tax-free to the bankruptcy estate. The court stated—

> This court has difficulty with the notion that the mere act of abandoning burdensome property creates tax liability for the trustee. The effect of such a rule could be to place the burden of any taxes arising from such "dispositions" upon the unencumbered assets which might otherwise be distributed to unsecured creditors.[38]

- The third case, *In re Olson,*[39] the bankruptcy trustee abandoned two tracts of land to the debtor. Apparently, the bankruptcy trustee did not file state or Federal income tax returns. Accordingly, the debtors proceeded to prepare *and file* state and Federal fiduciary income tax returns for the bankruptcy estate, duly reporting the gain.

The bankruptcy court in Olson relied upon the earlier case of *In re David Roger McGowan,*[40] but acknowledged that *McGowan* might have been "overbroad" in defining property abandonment as involving "termination of the estate" under I.R.C. § 1398(f)(2) but in a puzzling leap of logic concluded that "abandonments during administration should also be covered by § 1398(f)(2)." The court stated—

> The definition of "transfer" within the Bankruptcy Code is broad enough to encompass abandonments, and § 1398(f)(2) of Title 26 enables the court to determine the liability issue. The court concludes from the foregoing, that the abandonment by the trustee was a transfer other than by sale or exchanges which is excepted from tax consequences under 26 U.S.C. § 1398(f)(2).[41]

The obvious outcome was income tax liability for the debtor.

As for the charge that the debtor prepared and filed the income tax returns which were the responsibility of the trustee to file,[42] the court in response to the trustee's complaint and request for damages, agreed that the filing was not malicious and indicated that a separate hearing would be set on the issue of damages and costs.

Other developments

In 1988, the acting U.S. Trustee for the Districts of Minnesota, Iowa, North Dakota, and South Dakota advised all panel trustees of opposition to the entrapment theory and further advised that, moreover, panel trustees "*will not be authorized to abandon property to a specific designated party.*" [43] Such abandonments "to a specific designated party," namely to creditors have been approved by other bankruptcy courts.[44]

Under date of March 14, 1989, in response to a request from the Executive Office for the United States Trustees, the IRS Office of Chief Counsel stated that " . . . it is our position that abandonment is not a taxable event under I.R.C. § 1398."

Further arguments favoring entrapment

In addition to the points made above relative to the technical correctness of the entrapment theory, two additional arguments are worthy of note.

- The first is that the deflection theory is completely inconsistent with the idea of a "fresh start" for the debtor. As stated in a recent bankruptcy case—

> The Bankruptcy Code provides an honest debtor with a fresh start, free from the burden of past debts. *Brown* v. *Felsen*, 442 U.S. 127, 128, 99 S.C. 2205, 2207, 60 L.Ed.2d 767 (1979). This fresh start has been described as the most extensive "since the seven year release described in the Old Testament." *Bailey* v. *Bailey* (In re Bailey), 53 B.R. 732, 736 (Bankr. W.D. fry. 1985); *Fox* v. *Cohen* (In re Cohen), 47 B.R. 871, 873 (Bankr. S.D. Fla. 1985). . . .[45]

To leave a debtor with tens of thousands of dollars of tax liability, which is not dischargeable in that bankruptcy, is scarcely in accord with the concept of a fresh start.

- The second point is the obvious inequity of the deflection theory. That inequity can best be illustrated with an example.

Example 1: Farmer X files Chapter 7 bankruptcy with only two assets, A and B, both tracts of farmland.

[In dollars]

	A	B	Total
Basis	50,000	70,000	120,000
Fair market value	100,000	100,000	200,000
Secured debt	80,000	80,000	160,000

In addition, the debtor owes $100,000 of unsecured debt for a total debt of $260,000 against assets of $200,000. The debtor is clearly insolvent. The trustee in bankruptcy would not be expected to abandon either asset inasmuch as the secured debt is less than the fair market value of the asset in each instance. Rather, the trustee would be expected to sell both assets, thereby triggering $80,000 of gain ($200,000 in combined fair market value less $120,000 of combined basis). The debtor would receive a fresh start, the debtor should owe no Federal income tax and the trustee in bankruptcy would have $40,000 (less income tax liability on $80,000 of gain) for distribution to unsecured creditors.

Example 2: Assume now a neighbor, Farmer Y, files Chapter 7 bankruptcy with two assets, C and D, both tracts of farmland.

[In dollars]

	C	D	Total
Basis	50,000	70,000	120,000
Fair market value	100,000	100,000	200,000
Secured debt	100,000	60,000	160,000

In addition, Farmer Y owes $100,000 of unsecured debt for a total debt of $260,000, the same as Farmer X. The basis figures are the same for the two farmers.

Yet, in the case of Farmer Y, the trustee in bankruptcy would be expected to abandon tract C inasmuch as the property is worth no more than what is owed on it.

1. With the deflection theory, Farmer Y has $50,000 of gain when the secured creditor acquires tract C from the debtor. The bankruptcy estate presumably sells tract D, realizing $30,000 of gain, and distributes $40,000 to the unsecured creditors (less income tax liability on $30,000 of gain).
2. With the entrapment theory, the $50,000 of gain is trapped in the bankruptcy estate, the income tax basis on tract C becomes $100,000, Farmer Y has no gain and the bankruptcy trustee distributes $40,000 to the unsecured creditors (less income tax liability on $80,000 of gain). *Note that only with the entrapment theory are the two examples treated the same.*

It is submitted that, as a matter of policy, bankruptcy procedures should at least strive to treat equals equally. That would not be the case with the deflection theory. The debtor ends up with a tax liability, the unsecured creditors receive a greater distribution and the debtor is denied a fresh start.

The fundamental problem

The problem with abandonment is the lack of Federal statutory law governing the matter. That task rests with the Congress. It is my belief that the Bankruptcy Tax Act of 1980 should be amended to mandate the entrapment theory.

V. TAX FATE OF CHAPTER 12 FILERS

The final problem area inhibiting the restructuring of farm debt is the tax status of filers under Chapter 12 of the Bankruptcy Code. Chapter 12 has been used widely in the 12-North Central states, as noted in Table 1, and has had a major influence on restructurings for many situations out of bankruptcy.

TABLE 1.—CHAPTER 12 FILINGS IN THE NORTH CENTRAL REGION SINCE NOVEMBER 26, 1986

	1987						1988						1989		
	1-31	3-31	5-31	7-31	9-30	11-30	1-31	3-31	5-31	7-31	9-30	11-30	1-31	3-31	5-31
IL	46	121	179	233	250	282	9301	329	350	369	373	390	411	429	458
IN	30	74	153	199	216	292	322	339	351	365	376	384	395	406	411
IA	73	188	264	290	308	329	350	360	379	387	396	402	405	409	419
KS	59	102	139	210	244	275	299	312	323	334	342	347	356	361	366
MI	18	48	87	137	148	166	181	194	216	220	232	251	266	272	283
MN	46	69	91	120	126	142	154	155	168	173	180	192	204	223	234
MO	18	109	172	206	225	246	281	298	332	350	361	377	386	402	410
NB	96	220	409	491	556	578	626	674	704	722	741	750	765	782	799
ND	25	51	74	87	113	140	167	179	188	202	209	232	244	252	258
SD	106	208	315	438	465	486	502	525	544	552	560	575	592	604	619

TABLE 1.—CHAPTER 12 FILINGS IN THE NORTH CENTRAL REGION SINCE NOVEMBER 26, 1986—Continued

	1987						1988						1989		
	1-31	3-31	5-31	7-31	9-30	11-30	1-31	3-31	5-31	7-31	9-30	11-30	1-31	3-31	5-31
WI	38 578	89 1,279	129 2,012	154 2,565	179 2,830	199 3,135	213 3,396	226 3,591	241 3,796	250 3,924	258 4,028	271 4,171	281 4,305	290 4,430	301 4,558

Chapter 12 bankruptcy estates are not eligible for separate entity status under the Bankruptcy Tax Act of 1980 for Federal income tax purposes.[46] That legislation, which provides detailed guidance to handling tax matters in bankruptcy, is applicable only to individuals filing under Chapter 7 and 11. Indeed, the 1980 legislation *denies separate entity status to other bankruptcy filers.*[47] This seemingly overrides earlier law recognizing separate entity status in other settings.[48] Moreover, before enactment of the Bankruptcy Tax Act, even with separate entity status, the transfer of a bankrupt's assets to the trustee in bankruptcy was not a taxable event and the basis carried over to status in other settings.[48] Moreover, before enactment of the Bankruptcy Tax Act, even with separate entity status, the transfer of a bankrupt's assets to the trustee in bankruptcy was not a taxable event and the basis carried over to the trustee.[49] By specifically denying separate entity status to filers other than individuals filing under Chapters 7 or 11, it is clear that Chapter 12 filers are not eligible for separate entity status either under the Bankruptcy Tax Act or under pre-1980 case law and rulings.

Under the state of the law before enactment of the Bankruptcy Tax Act of 1980, investment tax credit was recaptured on the transfer of assets to the trustee in bankruptcy unless it was a mere change in the form of doing business.[50] Investment tax credit is not recaptured, nor is recapture triggered otherwise, for filings governed by the Bankruptcy Tax Act of 1980.[51]

The 1980 legislation also specifies that administrative expenses in bankruptcy are deductible for individuals filing under Chapter 7 or 11.[52] There was authority, before enactment of the Bankruptcy Tax Act, that at least some of the expenses of the bankruptcy estate were deductible under I.R.C. § 212.[55] Fe hanlter 12 filers, there is no clear authority even for deducting the administrative expenses.

Quite clearly. legislation is needed to make those filing for Chapter 12 bankruptcy eligible for separate entity status for Federal income tax purposes. Merely amending I.R.C. § 1398(a) to include Chapter 12 filers in the list of those eligible to utilize the Bankruptcy Tax Act of 1980 is all that would be required. It is noted that separate entity status already exists for Chapter 12 filers for purposes of state and local income tax purposes.[54]

FOOTNOTES

1. Treas. Reg. § 1.1011-2(c), Ex. 8.
2. *Id.*
3. See *Commissioner* v. *Tufts*, 461 U.S. 300 (1983).
4. See I.R.C. § 108.
5. See Consolidated Omnibus Budget Reconciliation Act of 1985, amending I.R.C. § 57(a)(9), Pub. L. 99-272.
6. I.R.C. § 61(a)(12).
7. I.R.C. § 108.
8. See I.R.C. § 108(a)(1)(A).
9. For a general discussion of the rule, see N. Karl, Agricultural Law § 39.03 [3] (1989). See also, N. Karl, "Planning Under Bankruptcy and Debtor Distress," 9 J. Agr. Tax'n & L. 157-164 (1987) (discussing the provision before 1988 amendments).
10. See I.R.C. § 108(g)(1).
11. See I.R.C. § 108(g)(2).
12. I.R.C. § 108(g)(3).
13. I.R.C. §§ 453B(f)(1), 453B(a). The remainder of this testimony is drawn from a forthcoming article, N. Karl, "Consequences of Excess Debt in Agriculture, 6 Agric. L. Update ——— (1989.
14. I.R.C. §§ 453B(f)(2).
15. For this purpose, related party is defined as in I.R.C. § 318(a), except for paragraph (4), and I.R.C. § 267(b).

16. Ltr. Rul. 8739045, June 30, 1987. See Karl, "Forgiveness of Principal of Installment Obligations," 10 J. Agr. Tax'n & L. 67 (1988).
17. Rev. Rul. 55-429, 1955-2 C.B. 252.
18. Rev. Rul. 68-419, 1968-2 C.B. 196.
19. Installment Sales Revision Act of 1980, Pub.L. No. 96-471, Sec. 6(a)(1) 94 Stat. 2247 (1980).
20. 11 U.S.C. § 554.
21. I.R.C. § 1398(f)(1). Contra: In the Matter of Rasmussen, 95 Bkrpcy. Rep. 657 (W.D. Mo. [Bkrpcy.] 1989).
22. *Id.*
23. The court, in *In re Rasmussen,* supra note 5, refers twice to the "personal liability" of the bankruptcy trustee for Federal income tax due from the estate. Such is not the case. See 31 U.S.C. § 3713(b) (bankruptcy trustee specifically excused from personal liability for Federal tax). If bankruptcy trustees were to bear personal liability for Federal taxes, as is the case with other fiduciaries, a more responsible attitude might be encouraged among trustees for filing tax returns and paying taxes due.
24. I.R.C. § 1398(f)(1).
25. I.R.C. § 1398(f)(2).
26. See Harl, *Debtor-Creditor Relations: Annotated Materials,* Part One at 1-27, 1-28 (1986).
27. See *Yarbro* v. *Commissioner,* 737 F.2d 479 (5th Cir. 1984).
28. 646 F.2d 1309 (9th Cir. 1980).
29. 8 Bkrpcy. Rep. 581, 591 (D. Utah [Bkrpcy.] 1981).
30. "Taxation of Abandonments in Bankruptcy," 10 J. Agr. Tax'n & L. 221 (1988).
31. Ltr. Rul. 8918016, January 31, 1989.
32. 461 U.S. 300 (1982).
33. 79 Bkrpcy. Rep. 13 (S.D. Iowa [Bkrpcy.] 1907).
34. 79 Bkrpcy. Rep. at 416.
35. ——— F. Supp. ——— (S.D. Iowa 1988).
36. 95 Bkrpcy. Rep. 104 (N.D. Iowa [Bkrpcy.] 1988).
37. See I.R.C. § 1398(f)(2).
38. 95 Bkrpcy. Rep. 104.
39. Bkrpcy. No. 85-023335 (N.D. Iowa [Bkrpcy.] 1989).
40. See note 24 *supra.*
41. *In re* Olson, ——— Bkrpcy. Rep. ——— (N.D. Iowa [Bkrpcy.] 1989).
42. See I.R.C. §§ 6012(a)(9), 6012(b)(4).
43. Emphasis in the original memorandum from Wesley B. Huesinga, Acting U.S. Trustee, dated January 5, 1988.
44. See *In re* Butler, 51 Bkrpcy. Rep. 261 (D.D.C. [Bkrpcy.] 1984).
45. *In re* bias, 95 Bkrpcy. Rep. 419 (N.D. Tex. [Bkrpcy.] 1988).
46. See I.R.C. § 1398(a).
47. I.R.C. § 1399.
48. E.g., Ralph Roger Bergman, T.C. Memo. 1985-256 (individual's bankruptcy estate was separate taxable entity); Rev. Rul. 78-134, 1978-1 C.B. 197 (separate entity for individual bankruptcy); Rev. Rul. 72-387, 1972-2 C.B. 632 (same); Rev. Rul. 68-48, 1968-1 C.B. 301 (separate entity created for bankrupt partnership treated as estate).
49. Rev. Rul. 78-134, 1978-1 C.B. 197.
50. See Henry C. Mueller, 60 T.C. 36 (1973), *aff'd and rev'd on other issues,* 496 F.2d 899 (5th Cir. 1974) (voluntary petition in bankruptcy to liquidate); Rev. Rul. 74-26, 1974-1 C.B. 7 (transfer to trustee to liquidate business).
51. See I.R.C. § 1398(f)(1).
52. I.R.C. § 1398(h)(1).
53. Rev. Rul. 68-48, 1968-1 C.B. 301, 302 ("usual costs of administration, including the referee's compensation, statutory compensation for the trustee and for the bankrupt's attorney, the trustee's bond premium. . . .") See Ralph Roger Bergman, T.C. Memo. 1985-256 (deductions for real estate taxes, interest and legal fees available to bankruptcy estate, not debtor); Herbert E. Cox, T.C. Memo. 1981-552 (bankrupts allowed to deduct portion of attorney's fee representing portion of debts that were business debts); Maurice Artstein, T.C. Memo. 1970-220 (portion of attorney's fee for filing bankruptcy petition not deductible in voluntary petition to liquidate in bankruptcy because not sufficiently related to trade or business and not deductible as expense in connection with transaction entered into for profit).
54. 11 U.S.C. § 1231.

Prepared Statement of Senator Nancy Kassebaum

Mr. Chairman we are here to discuss the so-called tax on going broke. We have been down this road before. In 1986 Congress unequivocally acted to solve the problem. We are here to correct a technical correction that was anything but technical. Somewhere along the line, the clear intent of Congress was substantially altered. Left unchecked, the technical correction will result in exactly the senseless hardship Congress sought to avert.

The issue has not change since 1986. Absent a specific provision to the contrary, farm debt forgiveness is treated as taxable income. This perverse tax policy, however, ignores the fact that qualified farm debt is forgiven only because the farmer is broke. The farmer does not have the money to pay the debt to the lender or the tax to the government. His only real alternative is to file for bankruptcy.

Such tax driven bankruptcies are senseless and devastate entire rural communities. To correct this Draconian problem, Congress stated very clearly there should be no tax on qualified farm debt forgiveness. In this regard, Congress stated that to the extent a farmer had any basis in his assets, it had to be written down. To the extent the debt forgiveness exceeded a farmer's basis, the conference report stated it would not be taxed. Congress voted for the Tax Reform Act on the basis of the conference report. The conference report explanation was accurately transmitted by the agricultural networks and wire services throughout the country. Farmers made decisions as to whether or not to declare bankruptcy based conference language.

Several months after the Tax Reform Act was signed into law someone substantively altered the conference report explanation and then justified it as a technical correction. I am pleased this committee is seeking to correct the so-called technical correction. As a matter of revenue such a action should be completely neutral.

Good tax policy encourages farmers to stay on the farm and out of bankruptcy. Let us waste no time in implementing this policy.

Prepared Statement of Eddie McLearan

My name is Eddie McLearan and I am a farmer in the Skiatook/Bixby/Tulsa area and farming has been my sole source of income for more than 30 years. From 1982 thru 1988, due to weather conditions, I have had crop failures and when I did make a decent crop, the price of soybeans ($5.00-$5.15 BU) was so low that it barely covered my cost of putting the crop in and left very little toward next year's crop. I tried selling some of my land but the Oklahoma economy was so depressed than even if I could have managed to find a buyer, I couldn't get enough for it to pay off my loans. Then the bank asked for a large payment (principal plus interest) and I was unable to refinance. I operate on a cash flow basis and gradually my debt exceeded my income and the value of my land and equipment.

I had been inquiring about and had received information on Chapter 12 and finally decided, as a very last resort, if I was going to save my farm and equipment and continue in what is a lifetime labor of love, I would have to seek relief from foreclosure under Chapter 12. I filed in January, 1988, and my Plan was approved in October, 1988, as a One-Day Plan as I was totally secured on all debt and I had no unsecured debt. I was released from bankruptcy on May 3, 1989 However, part of this One-Day Plan, and upon the advice of my attorney, was a deed-in-lieu to Citizens Security Bank in Bixby on a piece of land that was held by the bank as collateral on my largest loan. I assumed this deed-in-lieu would have the same tax treatment it would have had in Chapter 7 or 11 and become part of the bankruptcy estate or 1086 of the Internal Revenue Code would take care of the gain. Instead, it was treated as a sale and the bank sent me a 1099 for $450,000 to be taxed as ordinary income. Obviously, if this goes uncorrected I may not be able to pay for this tax load and continue to operate my farm and I will have simply traded one debt for another and I may be right back into bankruptcy.

When my CPA told me that under his understanding the normal rules under 1086 would not apply to my situation, he advised me to see a Tax Attorney who concurred with his opinion. I also started seeking help in other directions—mainly the farm hot lines where I came into contact with Ron Johnson with the Oklahoma Family Farm Services and learned of this pending legislation. I then filed for an extension on my taxes until August based on your proposed Bill #1041. If the Bill has not passed by August 15, we will need to seek a further extension until October 15, 1989.

I have had both my CPA and Tax Attorney go over this Bill thoroughly; we have conferred with other CPA's around the State of Oklahoma and we believe that the Bill, as written may not help me or other farmers in this situation because of the net worth requirements and the use of the tax attributes. The reasons and the changes we would like to propose at this Hearing are outlined in the attached letters, so I won't go into lengthy detail in this letter. I would like to state briefly, however, that if I have to use up all my tax attributes, which includes my Net Operating Loss, I may not be able to operate in any capacity. If I have to use the NOL to offset this gain under Chapter 12, I will not have the NOL to offset future income that will enable me to get back on my feet and service the debt I still owe. If I am able to reduce the basis in other property to offset the remaining gain after utilizing the tax attributes, in my situation, I may be able to postpone the tax on the gain. However, this will only prolong the problem and my CPA has not done enough research in this area to feel completely comfortable. Again I state, this will only increase my tax problems in the future if I am ever able to sell, or need to sell, some property to settle future debts and my basis has been reduced.

Also, we feel that the provision on equity in all property should be stricken from the Bill. Many farmers could easily have more than $147,000 in equity in their land and equipment. Certainly, in my case, I may have, depending on appraisals, have over this amount and therefore be excluded from the provisions of this Bill. Equity is very hard to define as it changes from day to day, and from appraiser to appraiser. We would like to propose these and a couple of other changes addressing the question of Modified Adjusted Gross Income which is covered in the attached letter from our Tax Attorneys.

Senator Boren, as you are aware, the farm crises is far from over. We desperately need this Bill and the recommended changes, not only for myself, but in order to save the "Family Farm" as there will be more and more farmers forced into foreclosure or Chapter 12 due to last year's drought. If this Bill and it's changes does not pass and become a law, and I am left with this massive tax bill, I will probably not have a chance to recover and I stand a very good chance of losing my farm, everything I have worked for and the way of life that I love.

Thank you very much for all your help and time on this problem.

Attachments.

MEMORANDUM

TO: Ron Johnson

FROM: Riseling & Associates, P.C.
2510 E. 21st Street
Tulsa, Oklahoma 74114

DATE: June 7, 1989

RE: Pending Legislation/Farm Debt Tax Reform Act S. 1041

The Farm Debt Tax Reform Act of 1989 is necessary legislation which will partially exclude gain when a farmer deeds property to a lender in satisfaction of the debt.

However, in reviewing the legislation, it appears several sections may present a problem and possibly defeat the following purpose of the legislation. The following outlines some of the problem areas:

1. Calculation of "Modified Adjusted Gross Income"

To qualify for the relief set forth in this Act, the farmer's Modified Adjusted Gross Income ("MAGI") must be less than 100% of the National Median Adjusted Gross Income. The legislation should specifically state that the MAGI excludes all gain from the transfer of farm property.

Assume the National Median Adjusted Gross Income is $30,000.00.

For example, if a farmer deeded back property which resulted in a $400,000.00 gain and had no other income, $350,000.00 would be excluded under the current act. Presumably the remaining $50,000.00 of gain from the transfer would be included in MAGI since there is no specific exclusion. This, of course, would disqualify the farmer from using this Act. In effect, this section would be inapplicable to any farmers whose gain exceeded $350,000.00 plus the entire amount of National Median Adjusted Gross Income.

To avoid this, the legislation should provide that in calculating MAGI, the entire amount of gain from the transfer should be excluded. The section by section analysis of the bill set forth in the congressional record covers this part by defining modified adjusted gross income as adjusted gross income plus tax exempt interest minus capital gains and discharge of indebtedness. Although the intent appears to exclude all gains relative to the transfer, the language of the present version of the bill excludes only gains up to $350,000.00.

2. Reduction of Tax Attributes

The Act also provides for reduction in tax attributes up to the amount of gain excluded. The bill does not explain if the tax attributes are used in the current year and then reduced, or reduced and then any remaining amount used.

In effect, this Bill is no help to a farmer with a net operating loss or other tax attributes equal to the amount of the excluded gain.

A farmer without tax attributes is benefitted dramatically more under the Act than a farmer with tax attributes. To avoid this inequity, the farmer should be allowed to use his tax attributes in the current year prior to offset current income prior to reducing the tax attributes.

Additionally, the Act should provide that the tax attributes can be taken into consideration in computing MAGI, otherwise a farmer with net income above the national median who is entitled to loss carryovers would not be benefited by the bill.

3. Other Considerations

The Act applies to farmers regardless of whether the transfer is made incident to a Chapter 12 bankruptcy. Chapter 12 provides absolutely no relief from federal tax liabilities. The Tax Bankruptcy Act (Title 26 U.S.C. Section 1398 et seq.) provides special tax provisions for debtors in a Chapter 7 or Chapter 11 bankruptcy which does not extend to Chapter 12 bankruptcies.

Often in a Chapter 12, as part of the farmers plan, he is required to deed property back to a lender.

Perhaps the Act could provided for an increased exclusion of gain if the transfer is made incident to a Chapter 12 bankruptcy.

REGIER CARR & MONROE Certified Public Accountants

MEMBER OF
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June 6, 1989

Mr. Ron Johnson, Research Analyst
Oklahoma Family Farm and Rural Services
2901 Classen Boulevard, Suite 125
Oklahoma City, Oklahoma 73106

Dear Mr. Johnson:

This letter is written on behalf of Mr. Eddie McLearen in regard to the bill cited as the Farm Debt Tax Reform act of 1989.

A concern of the draft of the bill as contained in the May 18, 1989 Congressional Record is the section regarding the "Deduction of Tax Attributes." If the $350,000 exclusion is granted and the tax attributes are reduced then the benefit to the farmer is reduced substantially. The taxpayer needs to maintain the tax attributes to continue to operate otherwise he may be back in bankruptcy.

Secondly, the section dealing with the taxpayers equity in all property should be eliminated. This provision could eliminate several farmers. The value of the taxes eliminated using their formula as I interpret it would be: [$350,000 X 28%] X 150% = $147,000, the maximum equity then that a farmer could have in all his property. This is not the tax basis, this is the equity which would mean the value of the property less debt. Several farmers and farms could have greater than $147,000 in equity in their machinery, their home and farm land. This provision could kill the bill and benefits for several farmers.

A section was added in the amended bill that would limit the debt equity ratio to 70% after the discharge on all property held by the taxpayer. This section should be stricken also as property is not defined and this has the same problems described in the previous paragraph.

Another problem with the two preceding paragraphs is the definition of equity. If the IRS in examining these returns 2 to 3 years after the filings questions the equity, how can one obtain a satisfactory appraisal?

These concerns were discussed in our phone conversation of June 6, 1989 and a highlighted copy of the Congressional Record is attached to show the specific areas concerned.

Yours very truly,

of REGIER CARR & MONROE

OBC/ra

cc: Mr. Eddie McLearen

Enclosures

Boren, Harkin, Mr. Kerrey, Mr. Dixon, and Mr. Burdick):

S. 1041. A bill to amend the Internal Revenue Code of 1986 to provide tax relief for farmers who realize capital gain on the transfer of farm property to satisfy an indebtedness, and for other purposes; to the Committee on Finance.

FARM DEBT TAX REFORM ACT

Mr. CONRAD. Mr. President, today I am introducing the Farm-Debt Tax Reform Act of 1989, a bill which addresses a number of special tax problems which can arise when farm assets are liquidated to satisfy farm debts or when farmers attempt to restructure their debts. This reform is absolutely essential to insure that the debt restructuring provisions of the Agricultural Credit Act of 1987 are implemented as Congress intended. Joining me on this legislation are Senator Tom Daschle, Senator David Boren, Senator Tom Harkin, Senator Bob Kerrey, Senator Quentin Burdick, and Senator Alan Dixon. I want to thank Senator Tom Daschle, Senator David Boren, Senator Tom Harkin, and their staffs for their advice and assistance on this legislation. I would also like to thank the Center for Rural Affairs in Walthill, NE, for their assistance.

The Agricultural Credit Act of 1987 provided for a rational, systematic approach to handling the delinquent farm debt resulting from the farm depression of the 1980's. As many of you know, net farm income during the first 5 years of the 1980's fell to the lowest level—in real dollars—since record keeping began in 1910—lower even than the worst 5 years during the Great Depression.

The deep recession of the 1980's left thousands of farmers with huge debts which they could no longer pay. The value of assets used in farming—land and machinery—plummeted in value by 60 percent or more. As a consequence thousands of farmers' debts exceeded the value of their assets. The Agricultural Credit Act offers farmers an orderly means of restructuring farm debt when restructuring result in a greater recovery to the lender than foreclosure. This orderly process can salvage a significant portion of the outstanding debt—strengthening the Farm Credit System, reducing losses to the Farmers Home Administration, and helping farmers with a crushing financial burden.

The Agricultural Credit Act of 1987 is a wise policy approach to the farm crisis and will be an important tool in the effort to rebuild rural America. The act gave farmers across the country the hope that they would be able to rebuild their lives and their farming operations. But without some corresponding changes in the tax law, that chance for a fresh start will elude many farm families. Many farmers who have applied for relief under the Agricultural Credit Act are finding that the tax consequences of their plans can be overwhelming. Other farmers who have lost everything and are now trying to start new lives and new professions—often at the age of 50 or 60—are faced with massive tax bills—the final insult to the loss of their homes and livelihoods.

One set of problems arises for farmers when they sell or deed over property to the lenders to satisfy their debts. If the property is worth more than they originally paid for it—even though it is encumbered with debt in excess of its value when deeded back—the farmer will have to count the difference as a capital gain and pay tax on it. It is the same tax a farmer would face if he sold the land free of debt, only in this case all the proceeds or the property itself goes to the lender. This is a particular problem for older, low-income farmers whose only option is to liquidate. If they bought their farms in the 1950's, the so-called gains can be significant.

Let me provide a numerical example. Suppose a farmer purchased land for $75,000 in 1955 and subsequently borrowed $200,000 on the land for farming purposes—a harvesting machine, for example, can cost $100,000—at a time when the land was worth $300,000. Today due to the farm recession, the land is worth $150,000 but has a debt of $200,000 against it. If the farmer conveys the land back to his lender to satisfy part of his debt he will have to pay a tax bill on $75,000 capital gain and on $50,000 forgiveness of debt income even though those gains really do not exist.

To offset this income, he can draw on any tax attribute such as operating losses and carryovers that he has. He will not be able to deduct 60 percent of the capital gain as he could before the 1986 tax act, nor can he average his income over a 5-year period. He will be taxed on the remainder unless he is insolvent.

In the example above, the farmer may be scaling down his farming operation to improve his cash flow or turning back the whole farm with the intent of repurchasing his home and a few acres. In either case, if the farmer is unable to pay the resulting tax liability, he will be unable to restructure. In fact, in most cases, even bankruptcy will not relieve the farmer of this tax liability. If rural America is to recover from the farm crisis, we have to leave these people with more than a tax bill.

This legislation addresses both of these problems for farmers who clearly lack the ability to pay. The bill would provide an exclusion of capital gain or discharge of indebtedness income for taxpayers who meet the following three tests: First, 50 percent of the taxpayer's gross receipts in at least 6 of these last 10 years must be attributable to farming; second, modified adjusted gross income is less than the national median; and third, equity in all property is less than $25,000 or 150 percent of the tax liability.

The exclusion is limited to $350,000 in capital gain or discharge of indebtedness income over the taxpayer's lifetime, and is available only after remaining tax attributes have been used.

Mr. President, I believe these tests are a fair way to target this relief. They are devised to prevent abuse and the possibility of manipulation by speculative investors or wealthy individuals.

These criteria are intended to provide a fresh start to farmers of modest income and means. This legislation is a responsible approach to the tax consequences of farm liquidation and debt restructuring. Like the Agricultural Credit Act of 1987, this bill balances public costs and budget constraints against the public obligation to respond to the farm crisis. It does nothing more than put farm families in a position from which they can rebuild their lives.

To sum up, this bill is a vital complement to the Agricultural Credit Act of 1987. Debt restructuring will not provide the opportunities we envision for farmers if it results in tax liabilities that they have no hope of ever being able to pay. I urge my colleagues to examine the effects of our current tax law on restructuring and to carefully review this legislation.

I ask unanimous consent that a letter to me from the National Save the Family Farm Coalition, dated May 1, 1989, and a section-by-section analysis and the text of the bill be printed in the Record.

There being no objection, the material was order to be printed in the Record, as follows:

S. 1041

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Farm Debt Tax Reform Act of 1989".

SEC. 2. CAPITAL GAIN REALIZED FROM TRANSFER OF FARM PROPERTY IN COMPLETE OR PARTIAL SATISFACTION OF QUALIFIED FARM INDEBTEDNESS EXCLUDED FROM GROSS INCOME.

(a) In General.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1986 (relating to items specifically excluded from gross income) is amended by redesignating section 135 as section 136 and by inserting after section 134 the following new section:

"SEC. 135. CAPITAL GAIN REALIZED FROM TRANSFER OF FARM PROPERTY IN COMPLETE OR PARTIAL SATISFACTION OF QUALIFIED FARM INDEBTEDNESS.

"(a) In General.—Gross income of any taxpayer described in subsection (d) does not include so much of the gain from the transfer of farm property in complete or partial satisfaction of qualified farm indebtedness as does not exceed $350,000.

"(b) Prior Gains and Discharges of Indebtedness Taken Into Account.—

"(1) In general.—If for any prior year—

"(A) gain from the transfer of farm property in complete or partial satisfaction of qualified farm indebtedness, or

"(B) a discharge of such indebtedness,

is excluded from the taxpayer's gross income under subsection (a) of this section or section 108(g), respectively, subsection (a) of this section shall be applied for the taxable year with respect to such gain by reducing the dollar amount contained in such subsection by the such excluded prior year gains and discharges.

"(2) Current year coordination with section 108.—Subsection (a) of this section shall be applied for the taxable year with respect to any gain by reducing the dollar amount contained in such subsection (after any reduction under paragraph (1)) by any amount excluded from gross income under section 108 for such year.

"(c) Reduction of Tax Attributes.—

"(1) In general.—The amount excluded from gross income under subsection (a) shall be applied to reduce the tax attributes described under section 108(b)(2).

"(2) Coordination with section 108.—For purposes of this subsection, the amount of tax attributes shall be determined after any reduction under section 108(b) by reason of amounts excluded from gross income under section 108(a)(1).

"(d) Taxpayer Described in This Subsection.—

"(1) In general.—A taxpayer is described in this subsection if—

"(A) such taxpayer's modified adjusted gross income for the taxable year in which the transfer of farm property in complete or partial satisfaction of qualified farm indebtedness occurs is less than 100 percent of the national median adjusted gross income,

"(B) more than 80 percent of the gross receipts of the taxpayer for 6 of the 10 taxable years preceding such taxable year are attributable to—

"(i) the trade or business of farming (within the meaning of section 2032A(e)(5)), or

"(ii) the sale or lease of assets used in such trade or business, or

"(iii) both,

"(C) such taxpayer materially participates (within the meaning of section 2032A(e)(6)) in the trade or business described in subparagraph (B)(i), and

"(D) equity in all property held by the taxpayer after such transfer is less than the greater of —

"(i) $25,000, or

"(ii) 150 percent of the excess (if any) of—

"(I) the tax imposed by this chapter determined as if this section and section 108 did not apply to the transfer, over

"(II) the tax imposed by this chapter determined with regard to this section and section 108 (if applicable).

"(2) Modified adjusted gross income.—For purposes of this subsection, the term 'modified adjusted gross income' means adjusted gross income—

"(A) determined with regard to this section and section 108, and

"(B) increased by the amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax.

"(3) Equity.—For purposes of this subsection, the term 'equity' means, with respect to any property, an amount equal to—

"(A) the fair market value of such property, minus

"(B) any indebtedness relating to such property.

"(e) Farm Property.—For purposes of this section, the term 'farm property' means real and personal property used by the taxpayer in the trade or business of farming (within the meaning of section 2032A(e)(5)).

"(f) Qualified Farm Indebtedness.—For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming (within the meaning of section 2032A(e)(5)).".

(b) Clerical Amendment.—The table of sections for part III of subchapter B of chapter 1 of such Code is amended by striking out the item relating to section 135 and inserting in lieu thereof the following new items:

"Sec. 135. Capital gain realized from transfer of farm property in complete or partial satisfaction of qualified farm indebtedness.

"Sec. 136. Cross references to other Acts.".

(c) Effective Date.—The amendments made by this section shall apply to transfers occurring after December 31, 1988, in taxable years ending after such date.

SEC. 3. EXCLUSION OF DISCHARGE OF QUALIFIED FARM INDEBTEDNESS FROM GROSS INCOME INCREASED FOR CERTAIN SOLVENT FARMERS.

(a) In General.—Section 108(g) of the Internal Revenue Code of 1986 (relating to special rules for discharge of qualified farm indebtedness) is amended by adding at the end thereof the following new paragraph:

"(4) Special limitations for certain farmers.—

"(A) In general.—With respect to a taxpayer who is described in subparagraph (C) of this paragraph—

"(i) the amount excluded under subparagraph (C) of subsection (a)(1) shall not exceed $350,000, and

"(ii) paragraph (3) of this subsection shall be applied without regard to subparagraph (B) thereof.

"(B) Prior discharges of indebtedness and gains taken into account.—If for any prior year—

"(i) a discharge of qualified farm indebtedness, or

"(ii) gain from the transfer of farm property in complete or partial satisfaction of such indebtedness,

is excluded from the taxpayer's gross income under this subsection or section 135, respectively, subparagraph (A) shall be applied for the taxable year with respect to such discharge by reducing the dollar amount contained in such subparagraph by the such excluded prior year discharges and gains.

"(C) Taxpayer described in this subparagraph.—A taxpayer is described in this subparagraph if—

"(i) such taxpayer's modified adjusted gross income for the taxable year in which the discharge of qualified farm indebtedness occurs is less than 100 percent of the national median adjusted gross income,

"(ii) more than 50 percent of the gross receipts of the taxpayer for 6 of the 10 taxable years preceding such taxable year are attributable to—

"(I) the trade or business of farming (within the meaning of section 2032A(e)(5)), or

"(II) the sale or lease of assets used in such trade or business, or

"(III) both,

"(iii) such taxpayer materially participates (within the meaning of section 2032A(e)(6)) in the trade or business described in clause (ii)(I),

"(iv) the indebtedness of the taxpayer both before and after such discharge is equal to 70 percent or more of the equity in all property held by such taxpayer,

"(v) equity in all property held by the taxpayer after such discharge is less than the greater of—

"(I) $25,000, or

"(II) 130 percent of the excess (if any) of the tax imposed by this chapter determined as if this section and section 135 did not apply to the transfer, over the tax imposed by this chapter determined with regard to this section and section 135 (if applicable), and

"(vi) such taxpayer, in transferring property in connection with the discharge of qualified farm indebtedness, transfers only farm property.

"(D) Definitions.—For purposes of this paragraph—

"(i) Farm property.—The term 'farm property' means real and personal property used by the taxpayer in the trade or business of farming (within the meaning of section 2032A(e)(5)).

"(ii) Modified adjusted gross income.—The term 'modified adjusted gross income' means adjusted gross income—

"(I) determined with regard to this section and section 135, and

"(II) increased by the amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax.

"(iii) Equity.—The term 'equity' means, with respect to any property, an amount equal to—

"(I) the fair market value of such property, minus

"(II) any indebtedness relating to such property.".

(b) Conforming Amendment.—Subparagraph (A) of section 108(g)(3) of such Code is amended by striking out "The amount" and inserting in lieu thereof "Except as provided in paragraph (4), the amount".

(c) Effective Date.—The amendments made by this section shall apply to discharges of indebtedness occurring after December 31, 1988 in taxable years ending after such date.

Farm-Debt Tax Reform Act of 1989

Section-by-Section Analysis

Section 1: Short title. This Act may be cited as the "Farm Debt Tax Reform Act of 1989".

Section 2: Provides an exclusion for capital gains that arise when farm property is transferred to a lender in exchange for debt relief if the following conditions apply:

The exclusion of gains under this section (plus the exclusion of ordinary income in Section 2) does not exceed $350,000 over the taxpayer's lifetime;

The excluded amounts are used to reduce tax attributes to the extent possible;

The taxpayer's modified adjusted gross income is less than 100 percent of the national median adjusted gross income;

At least 80 percent of the taxpayer's gross receipts in at least 6 of the last 10 years is attributable to farming or the lease or sale of assets used in farming, and the taxpayer must have materially participated in the trade or business of farming;

The taxpayer's equity in all post transfer property is less than $25,000 or 150 percent of the tax liability, whichever is greater.

Definitions: Modified adjusted gross income means adjusted gross income plus any tax-exempt income minus capital gains and discharge of indebtedness income;

Equity means the fair market value of property minus any indebtedness on such property;

Tax liability for the purpose of the equity test is the difference between the tax that would be owed under the current law and the tax that would be owed under the bill;

Farm property means real and personal property used in connection with the trade or business of farming; and

Qualified farm indebtedness specifies the farming purposes (cultivation of soil, handling of animals, forestry, etc.) for which the debt was incurred.

Effective date: Section 1 applies to all transfers occurring after December 31, 1988.

Section 3: Provides for an exclusion of discharge of indebtedness income (ordinary income) for farmers who meet the following conditions, as an alternative to the 50 percent farm income test which now provides a limited exclusion for solvent taxpayers under section 108(g):

The exclusion is limited to $350,000 over the taxpayer's lifetime (counting any excluded gains under Section 1);

The taxpayer's modified adjusted gross income in the year of the discharge is less than 100 percent of the national median adjusted gross income;

At least 50 percent of the taxpayer's gross receipts in at least 6 of the last 10 years is attributable to farming or the lease or sale of assets used in the trade or business of farming and the taxpayer must have materially participated in the trade or business of farming;

The taxpayer's debt of equity ratio both before and after the transfer is at least 70 percent;

The taxpayer's equity in all post-transfer property is less than $25,000 or 150 percent of tax liability, whichever is greater.

Definitions: same as for Section 1.

Effective date: Section 3 applies to all transfers and restructuring occurring after December 31, 1988.

Ron Johnson

NATIONAL SAVE-THE FAMILY FARM COALITION,
Washington, DC, May 1, 1989.

Hon. KENT CONRAD,
U.S. Senate, Washington, DC.

DEAR SENATOR CONRAD: On behalf of the Credit Committee of the National Family Farm Coalition representing over 40 organizations in 35 states, I would like to express our strong support for the Farmer Tax Reform Act of 1989 and to thank you for your leadership on this most important issue. The hard-fought victory for families in the Agricultural Credit Act of 1987 providing sensible debt restructuring when it is the least cost alternative will be a hollow victory if the FmHA debt is replaced by a lifetime IRS debt.

As family farmers struggling to save our farming operations through the new debt restructuring options in the Agricultural Credit Act and fair treatment under Chapter 12 bankruptcy, we view this new legislation as a top priority to achieve the goal of enabling family farmers to stay on their farms and in their rural communities.

As you are most aware Senator Conrad, the past six months have been a period of uncertainty for tens of thousands of family farmers struggling to work through the FmHA debt restructuring process. For thousands more, the Farm Credit Services have not provided farmers with the kind of debt restructuring many of us had hoped would be the outcome of the Ag Credit Act. Some farmers have received the good news that they are eligible for a debt-write down or other option as it is the least cost alternative to the federal government in resolving their debt crisis. For these farmers, the tax implications of debt-write down or past debt settlements with FmHA are unclear.

We look forward to working with you to ensure passage of this important legislation. To farmers planting this Spring, you leadership and action is a sign that there is a commitment to seeing the Agricultural Credit Act really help farmers stay on their farms and in their rural communities. We thank you for your support.

Sincerely,

BENNY BUNTING,
Chair, NFFC Credit Committee.

By Mr. DURENBERGER:

S. 1042. A bill to suspend temporarily the duty on certain in-line roller skate boots; to the Committee on Finance.

SUSPENSION OF DUTY ON IN-LINE ROLLER SKATE BOOTS

● Mr. DURENBERGER. Mr. President, I rise to introduce legislation that would temporarily suspend tariffs on certain boots that are incorporated into in-line roller skates manufactured and assembled in the United States. This legislation would help overcome an unfair competitive advantage that importers of fully assembled roller skates currently have against domestic roller skate manufacturers.

Rollerblade, Inc., a Minnesota corporation, manufactures in-line roller skates. Some of the roller skate components used by this company are domestically sourced, and others are imported from Italy, Austria, and Taiwan.

Currently, skate boots imported for the roller skate carry a 6-percent duty. These skate boots are not useable in the form in which they enter the country. Instead, they must go through a manufacturing process to have "wheel supports" attached.

Rollerblade's domestic competitors import finished roller skates from Taiwan. As a finished product, these roller skates enter the United States duty free. This clearly enables domestic competitors who import finished products to gain an unfair, and unintended, competitive advantage against a company that is creating manufacturing jobs in the United States. That makes no sense.

My legislation would redress this unfair competitive advantage by reclassifying these boots as duty-free roller skate parts.

Mr. President, I ask unanimous consent that the full text of the legislation I am introducing be reprinted in the RECORD.

There being no objection, the bill was ordered to be printed in the RECORD, as follows:

S. 1042

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That Subchapter II of chapter 99 of the Harmonized Tariff Schedule of the United States is amended by inserting in numerical sequence the following new subheading:

"9902.64.02	Skating boots (provided for in subheading 6402.19.10) [illegible]	Free	No change	No change	On or before 12/31/92"

SEC. 2. (a) The amendment made by the first section of this Act applies with respect to articles entered, or withdrawn from warehouse for consumption, on or after the 15th day after the date of enactment of this Act.

(b) Notwithstanding section 514 of the Tariff Act of 1930 or any other provision of law, upon proper request filed with the appropriate customs officer within 90 days after the 15th day after the date of enactment of this Act, any entry—

(1) that was made after April 30, 1988, and before such 15th day; and

(2) with respect to which there would have been no duty if the amendment made by the first section of this Act applied to such entry;

shall be liquidated or reliquidated as though such amendment applied to such entry ●

By Mr. FORD (for himself, Mr. LAUTENBERG, and Mr. MITCHELL):

S. 1043. A bill to establish a Commission on Aviation Security and Terrorism to investigate the adequacy of and compliance with aviation security procedures and Federal Aviation Administration security requirements; to the Committee on Commerce, Science, and Transportation.

AVIATION SECURITY AND TERRORISM COMMISSION ACT OF 1989

● Mr. FORD. Mr. President, the tragic loss of Pan American Airways flight 103 over Scotland on December 21, 1988 has focused the attention of the world on the critical importance of aviation security. The resulting loss of 259 lives aboard the Boeing 747 aircraft, as well as 11 others in the town of Lockerbie, underscores the importance of our making every effort to improve the aviation security and counterterrorism activities of the United States.

Much has been done in the intervening months by the Secretary of Transportation and the Federal Aviation Administration to enhance aviation security. However, many continue to harbor concerns that these actions are too late and that more must be done. I share the belief that we must do whatever is necessary to ward off international terrorism and protect the lives of American citizens.

On April 3 of this year, the families of the victims of Pan Am 103 support group traveled to Washington at their own expense, seeking support for an independent investigation into the circumstances surrounding the bombing of Pan Am 103. Mr. President, that effort carries on today. Family members of those who lost their lives last December continue to call for a congressional investigation to resolve unanswered questions, contentions, and allegations regarding the events leading up to and surrounding the Pan Am 103 incident. By their most recent count, the victims' families claim the support of 60 Senators for such an investigation.

As chairman of the Aviation Subcommittee, it is my belief that if an investigation is to be conducted into this tragic incident, it is best done by an independent group, comprised not only of Members of Congress, but experts in aviation safety and security as well. Such a group will ensure that all concerns related to this incident are addressed and, hopefully, resolved.

PREPARED STATEMENT OF SARAH VOGEL

Good morning Senator Boren, members of the Committee. For the record, I am Sarah Vogel, Agriculture Commissioner for the State of North Dakota. I appreciate the opportunity to testify before your committee this morning on this vitally important matter.

In 1983, as a private attorney I filed a class action lawsuit against Agriculture Secretary John Block for the foreclosure practices of the Farmers Home Administration. Eventually, we won the lawsuit because, the judge said, FmHA was not following the law on allowing farmers to apply for deferrals and was denying farmers due process of the law with its foreclosure proceedings. Following the initial ruling were more complaints, injunctions, appeals and general litigation to bring the FmHA into compliance with its borrowers' constitutional rights. The dispute ran on for several years, until Congress passed the Agricultural Credit Act of 1987 (the Act), guaranteeing certain debt forbearance, deferral and settlement rights for FmHA and Farm Credit Service borrowers.

The Act also provides that a farmer's debt should be restructured -- through several available options -- when it's cheaper for the government to restructure that debt than it would be for the government to foreclose. The reality that guided the formation of this policy is that the government is better off recovering what debt the farmer can feasibly pay, while keeping the farmer in business and therefore productive and able to make payments in coming years.

Though the Act has not meant salvation for all borrowers of FmHA and FCS, it has helped many remain on the land and get a new start, or at a minimum, settle their debts with FmHA and/or FCS, retain their homestead and begin a new life.

The beneficial outcomes of debt restructuring procedures with FmHA and FCS often come to a screeching halt when the IRS contacts the borrower, notifying that person that they owe taxes -- usually a large amount -- on the "gain" they "realized" when their debt was or would be restructured or settled. This is especially true when land encumbered by debt has been or would be transferred through some means -- perhaps voluntary conveyance, deedback, or a sale to raise money to pay-off debt.

On paper, these land transfers may appear to generate income for the farmer/debtor. In reality, though, little could be further from the truth. The debtor rarely sees money from land sales for debt settlement; furthermore, land conveyed or deeded back to the creditor to satisfy debt does not result in "income" for the debtor, but rather merely a reduction of debt.

Unfortunately, current U.S. tax law does not distinguish between land sold under economic distress or turned over to satisfy debt and other transfers of property for profit. In other words, current U.S. tax law is not reflective of the reality being faced by many in American agriculture today.

FmHA issued more than 66,000 notices to delinquent farmers last year, indicating that if the farmers qualified, they had debt settlement options. If farmers were unable to meet the requirements for debt settlement, their accounts would be "accelerated", which ultimately leads to foreclosure or so-called "voluntary" conveyance. As of early July, FmHA plans to issue nearly 16,000 more notices to delinquent borrowers this fall. According to FmHA officials, only 12,500 farmers of the initial 66,000-plus who received notices last year were able to take advantage of some form of debt settlement. Figures released by the Center for Rural Affairs indicated that of the first 66,000 thousand, more than 31,000 were unable to meet debt settlement requirements and therefore had to either face foreclosure or transfer some land or property to FmHA to reduce their debt load. These 31,000 farmers, no doubt, will be facing stiff tax bills from IRS resulting from the options circumstances have forced them to choose.

Contrary to popular belief, many of the farmers who are facing high tax bills resulting from farm debt settlement are not those farmers who bought land when prices were high and who enthusiastically over-expanded when the agricultural economy was booming in the latter 1970s and very early 1980s. Quite the opposite, in fact, is true. (In truth, most people who bought land when prices were high and over-expanded their operations will show losses because their purchase price is higher than current market value.) The people most adversely affected by current U.S. tax law in this context are older farmers who bought the land decades ago at prices that now seem unbelievably cheap -- $40 - $100 dollars an acre, depending on the land -- and were forced out of farming or forced to give up a portion of their farm land to satisfy debt. The problem arises because this land is currently valued at much higher prices. Often, these unfortunate farmers have accrued debt against their land during years when cost of production greatly exceeds crop prices and through rolling over operating debts. So, the difference between the purchase price and what the land is worth when transferred to settle debt is most often negated by the debt that land carries.

Let me provide an example using a situation faced by one of the first FmHA restructure cases in North Dakota that "worked" -- and I use the term loosely. An elderly gentleman was up to his neck in debt to FmHA, his health was failing and all he wanted to do was to get out of debt to FmHA and have enough money left for minimal living expenses. Staff at North Dakota's Agricultural Mediation Service -- which is a division within the state Agriculture Department -- worked out a debt settlement plan that both FmHA and the farmer could live with. However, when accountants put their pencils and calculators to the plan, they realized the gentleman would have a $30,000 tax liability as a result of the settlement. This person has virtually no income. His hospital bills were mounting daily due to heart problems, yet because of current U.S. tax laws, the only thing this man can do is hold onto his farm land until he dies. What kind of existence is that? What sense does it make to have him retain the land and leave it idle, when his sons are willing and able to take over? Tax laws, in this case, have resulted in wasted years for an ill, elderly man, for his sons, and for the federal government because no income is being earned from the land, which means no federal taxes are being paid on it.

Because of the tax liability, his debt settlement plan with FmHA was abandoned. Just yesterday, I spoke with an official from FCS in North Dakota who informed that several plausible debt settlement plans have been negated because of the resulting tax liability. In this scenario, everyone loses, the farmer, the lending institution, the government and ultimately the remainder of the American taxpayers.

Let me present another example, this time using fictitious people. Let's say a farm couple in their mid-60s bought a farm after they were married and paid $40,000 for it. Now, it's 1989, the land is valued at $300,000 and over the years they have accumulated $300,000 worth of debt on the land, giving them a debt to asset ratio of 1/1. In debt settlement, they deed back to FmHA 75 percent of their land (or $225,000), and keep 25 percent (valued at $75,000). Of the 25 percent that they keep, $30,000 represents the homestead, which they get free and clear in the debt settlement agreement, leaving them with $45,000 worth of debt against the remaining land.

The IRS looks into the matter and views the $225,000 deedback, minus the $40,000 purchase price as a $195,000 capital gains. On paper, the couple ends up with a debt to asset ratio of approximately 1/2.5. What the IRS does not take into consideration, because of current tax law, is that the couple has a reduced asset base. Instead of looking at what the farmer is left with, which is a negative debt to asset ratio ($30,000 in assets, $45,000 in debt), they look at what the creditor gets and view it as the farmer's gain. The resulting tax liability for the couple, based on current law, will be approximately $64,350, or 33 percent of the $195,000 "capital gain". It should be clear from this example, that the couple will be completely unable to pay this tax. Where would the money come from?

For several years, I have been taking calls from farmers concerned about circumstances quite similar to those I just illustrated. Recent conversations with farm and tax attorneys in North Dakota have revealed farmers left with tax debts ranging from $6,000 (this person had no income) to up to $500,000 resulting from debt settlement via deedback, conveyance and bankruptcy.

Not only does this tax seem inherently unfair as perceived by the agricultural producers, it is unrealistic because the taxes are virtually uncollectible. To put it simply, the money is not out there, folks. As the old cliche goes, "you can't get blood from a turnip or whiskey from a rock."

A study done at North Dakota State University on the consequences of farm liquidations in recent years indicates that this problem is widespread in North Dakota. According to that study, contingent tax liabilities were a substantial problem for many people trying to liquidate their farm operation. Approximately 42 percent of people who responded to NDSU's survey indicated that liquidation resulted in increased tax liabilities. (See attachment). The average liability resulting from liquidation was $20,000. Further, the study revealed that most families who liquidated or left their farming operations because of debt had very limited income. The median family income for the group was $18,000; 29 percent of those responding to NDSU reported incomes of less than $10,000. For approximately one-third of the respondents, debt exceeded the value of their assets after liquidation. Finally, another 17 percent reported a positive net worth of $10,000 or less.

For these reasons, among other, the North Dakota Department of Agriculture offers its support to S. 1041. As introduced, Senator Kent Conrad's bill will provide an income exclusion for capital gain for farmers who transfer agricultural property to satisfy farm debt. The legislation also allows an income exclusion for discharge of indebtedness income. These two provisions are critical for the survival of many people in rural America.

The Department of Agriculture received an advance copy Thursday of the testimony of Center for Rural Affairs' Annette Higley, and we concur with the changes recommended by Ms. Higley in the written testimony submitted to the Committee today. These recommended changes would provide relief more equitably and would prevent non-farmers, i.e., investors, from benefiting from this legislation.

In closing, I would like to urge the Committee to work for quick passage of this bill. It's timely passage is a matter of financial life and death to many people in American agriculture. Further, any delay in passage could prevent this legislation from being as beneficial as is currently possible.

Thank you, Senator Boren, members of the Committee, for your attention.

Table 4. Contingent Tax Liabilities of Former North Dakota Farmers

Item	Number	Value
Did ceasing to farm result in additional income tax liabilities?	161	
No		42.9%
Yes		42.2
Don't know		14.9
Total additional tax liability	62	
Average		$20,117
Distribution:		
$0–$4,999		27.4%
$5,000–$9,999		12.9
$10,000–$14,999		16.1
$15,000–$19,999		11.3
$20,000–$29,999		9.6
$30,000–$39,999		12.9
Over $40,000		9.7
Factors contributing to additional tax liabilities	92	
Recapture of investment credits		52.2%
Recapture of depreciation		48.9
Additional capital gains taxes		52.2
Debt forgiveness		25.0
Other		6.5

PREPARED STATEMENT OF SHARON K. WATKINS

Thank you, Mr. Chairman and this committee, for the opportunity to speak to you on the subject of Senate Bill 1041. On behalf of the Credit committee of the National Family Farm Coalition representing over 40 organizations in 35 states, I would like to express our support for swift action by this Congress on the Farm Debt Tax Reform Act of 1989 and to thank you for your leadership on this most important issue. My testimony today will focus on areas of concern that have been raised by farmers working with the Credit Committee since the bill's introduction.

As family farmers struggling to save our farming operations through the new debt restructuring options in the Agricultural Credit Act, we view this new legislation as a top priority to achieve the goal of enabling family farmers to stay on their farms and in their rural communities.

I am Sharon K. Watkins, a farmer and accountant from southern Indiana. With my young son, I farm 500 acres. We raise corn, soybeans, tobacco, wheat, hay and livestock. I also have an accounting practice. Besides doing over 100 farm tax returns each year, I assist farmers in restructuring their farm debts. Working either directly with the farmer or with several attorneys in Indiana, I prepare balance sheets, cashflows, other financial reports and restructuring plans as requested by the court, creditors and others.

It is my opinion that passage of S. 1041 in 1989 is as important to farmers as the passage of the Agricultural Credit Act was in 1987. It was your leadership, Mr. Boren, in the Senate Agriculture Credit Subcommittee, that helped to ensure that farmers received borrowers' rights through that legislation. Now, many of these same borrowers are not able to make the important decisions on their future due to uncertainty over the tax consequences of this legislation. We agree with the recent IRS ruling on the impact of shared appreciation agreements and the timing for tab liability, yet we feel it should be incorporated into the statute so that farmers and their accountants are fully aware of its existence.

Many farmers are now trying to restructure their debts with their lenders, especially with the Farm Credit System and Farmers Home Administration. This tax provision is critical for them, as well as those borrowers who are not able to continue farming and have no feasible plan of restructuring, to present other than a sale or conveyance of all or part of their assets. If they file a Chapter 11, again the question of feasibility would come up, but if they are liquidated, the Chapter 11 rules would help with the tax problem. The major drawback to a Chapter 11 is its cost of thousands of dollars. Dollars, that S. 1041, by avoiding bankruptcy for these farmers, would make available to pay creditors. Plus, many farmers would scale back their operations rather than do a complete liquidation if given the choice. But those choices are taken from them if they must file a Chapter 11 to avoid taxes they cannot pay. The court, trustee and creditors take control of their operation in a bankruptcy.

Attached to this testimony for the record are tax returns, using 1988 tax rates, of a farmer who is considering conveying his property to his creditor. The difference in the tax liability as demonstrated by Exhibits 1 and 1A is $104,543.00 using the maximum amount of capital gain of $350,000.00. The question of whether he would be liable for taxes of $104,543.00 means the difference between this particular farmer being able to restructure his debts or file Chapter 11 bankruptcy. He has a restructuring plan approved by Farm Credit Service, his only creditor. The tax question is the only remaining issue to be resolved.

If S. 1041 is enacted it will not reduce taxes but will delay collection time for the taxes. In the above example, if this farmer chooses to file Chapter 11 bankruptcy he would eventually be discharged from the bankruptcy and not owe any taxes nor would he have his basis in his remaining real estate adjusted. When his real estate is eventually sold or considered in his estate at death, he would not owe more taxes because of his bankruptcy restructuring. If S. 1041 is enacted in its current form, he would owe more taxes if he chooses to use the provision of the law, because of tax attributes being adjusted. Not only the basis in the real estate would be adjusted, but immediately, the loss of the use of carryover net operating losses and investment credits would result in more tax revenue being collected annually. We would urge this Subcommittee to modify the order of the tax attributes to ensure that the legislation benefits those farmers who have been operating at a loss.

The best business decision would be to file bankruptcy and not use S. 1041 in its current form, but I assure you my experience with farmers is they would choose the provisions of this bill rather than file bankruptcy. Most farmers would take any other option given to them before they would choose bankruptcy.

S. 1041 would not result in lost revenues. In fact, it would result in eventually collecting more taxes plus cost less because fewer farmers would file bankruptcy. I have no idea what the cost to the government is for a farmer's bankruptcy, but the farmer's cost is $15,000.00 at a minimum. The cost to the government for maintaining courtrooms and salaries of judges, clerks and trustees are certainly not covered by the $200.00 filing fee. And by giving farmers another option during restructuring, more money is available for their creditors now.

I have a concern about the definition of "equity" in the language of the bill. I would like to be assured equity in all property means total balance sheet net worth even if this amount is negative. Attached as Exhibit 2 is a Balance Sheet and Equity Analysis of a farmer. The "Equity Analysis" is the accepted way I have always been instructed by attorneys and bankruptcy courts to prepare analyses. Please note, the difference between net worth and net equity in my example is $50,000. Using the Equity Analysis he is not eligible for Senate Bill 1041 tax relief but is eligible under the Net Worth test.

Most farmers with financial difficulties have found it necessary to finance their own operations and provide for a full year's family living expenses. This necessitates a farmer having a large inventory or cash balance at the end of harvest. Perhaps more than the $25,000 maximum equity should be allowed, or there should be a different way to incorporate the. family living expenses into that calculation.

Attached as Exhibit 3 for the record are several Balance Sheets and a Cash Flow. My example, which I believe is typical of the majority of Mid-West farmers, is of a row crop or grain farmer, who does not have an off-farm job or raise livestock. Income is only once a year at fall harvest time. This finances the entire operation providing one year of family living expenses from the sale of the crop of the preceding year. Because a growing crop is valued at the lower of cost or market value and the consumption of the family living allowance, this farmer is eligible some of the time, but ineligible the balance of the year. His net worth and date of that net worth are listed below.

Attachments.

January 1, 1988	$50,000
April 1, 1988	30,488
July 1, 1988	10,887
October 1, 1988	(3,337)

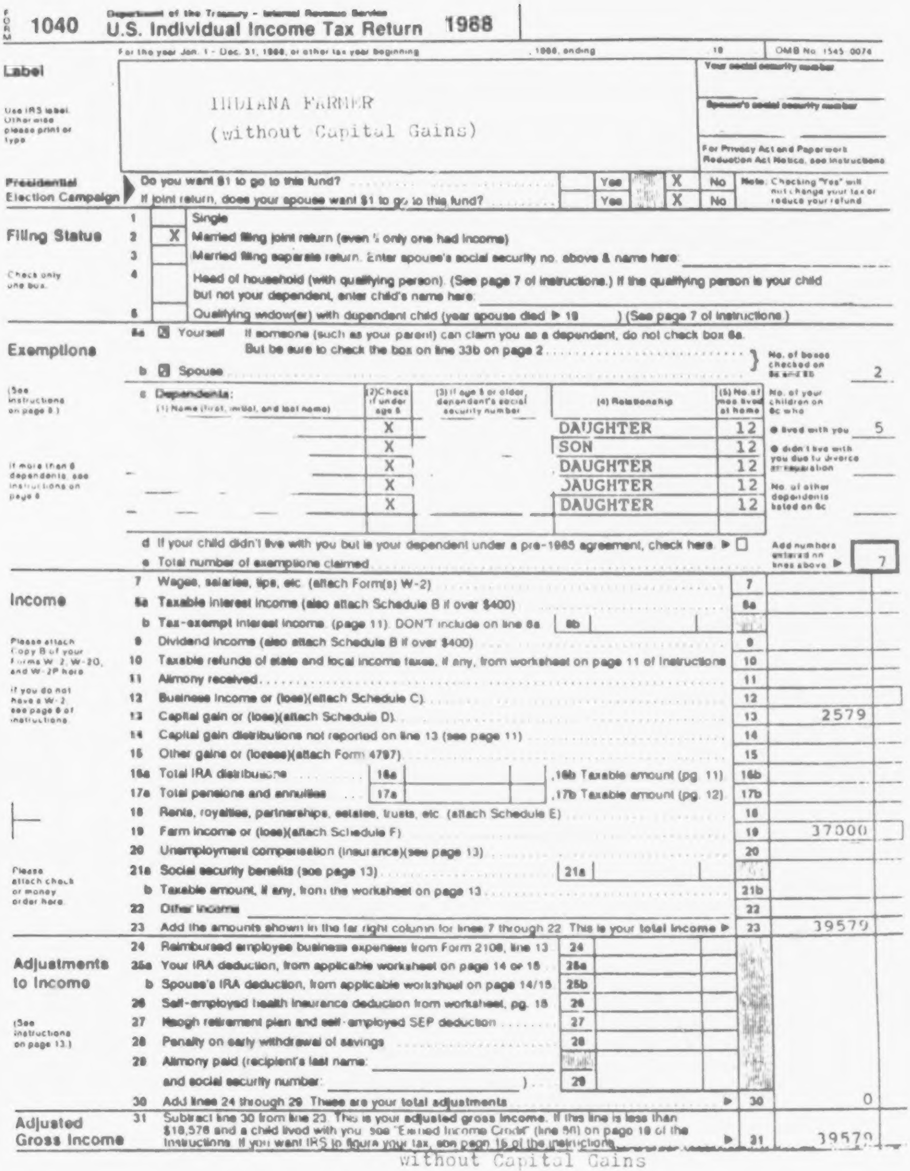
My calculations show (Exhibit 4) with a capital gain of up to approximately $59,500, a farmer would be allowed a maximum net equity of $25,000 and with a maximum capital gain of $350,000, a farmer would be allowed to have a net equity of an estimated $147,000. Experience would suggest most farmers would fall in the lower range and as the above example shows, it would depend on the timing of the sale or conveyance as whether many farmers would be eligible to use the provisions. Most farmers and creditors would not consider the timing or would not have enough control of the events surrounding the sale or conveyance to time events at the optimum time.

Following are some additional areas that we feel need to be closely examined by this Committee and hopefully included in the final legislation. They relate to the farmer definition in the legislation. We want to be sure that farmers who went through debt settlement during the period of the Coleman injunction, at which time FmHA interpreted the injunction to mean that they could not finalize debt settlements, are able to benefit from these provisions of capital gains exclusion. The farmer definition requires that 50% of the gross receipts have been from farming for six of the past ten years. While this may help some of the borrowers in 1989, we are concerned that it may be an unintentional barrier for farmers ten years from now. We support a provision in the bill that would specifically address farmers affected during this recent time-frame. In addition we support changing the material participation test to the qualified farm indebtedness section, removing it from the farmer definition.

Thank you for allowing me the opportunity to comment on this bill. We look forward to working with you to ensure swift passage of this important legislation. This is an important step towards meeting the goals of the Agricultural Credit Act for many farmers. It will help farmers stay on their farms and small businesses remain as our implement dealers, which directly strengthens our rural communities.

If I may answer any questions I would be more than happy to do so. Thank you.

Exhibit 1



FORM 1040 Department of the Treasury - Internal Revenue Service
U.S. Individual Income Tax Return 1988

For the year Jan. 1 - Dec. 31, 1988, or other tax year beginning , 1988, ending , 19 OMB No. 1545-0074

Label

Use IRS label. Otherwise please print or type.

INDIANA FARMER
(without Capital Gains)

Your social security number

Spouse's social security number

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Presidential Election Campaign	Do you want $1 to go to this fund?	Yes	X	No	Note: Checking "Yes" will not change your tax or reduce your refund.
	If joint return, does your spouse want $1 to go to this fund?	Yes	X	No	

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above & name here:
4 ☐ Head of household (with qualifying person). (See page 7 of Instructions.) If the qualifying person is your child but not your dependent, enter child's name here:
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19) (See page 7 of Instructions.)

Exemptions

(See Instructions on page 8.)

6a ☒ Yourself If someone (such as your parent) can claim you as a dependent, do not check box 6a. But be sure to check the box on line 33b on page 2
b ☒ Spouse
No. of boxes checked on 6a and 6b: 2

c Dependents:

(1) Name (first, initial, and last name)	(2) Check if under age 5	(3) If age 5 or older, dependent's social security number	(4) Relationship	(5) No. of mos. lived at home
	X		DAUGHTER	12
	X		SON	12
	X		DAUGHTER	12
	X		DAUGHTER	12
	X		DAUGHTER	12

If more than 6 dependents, see Instructions on page 8.

No. of your children on 6c who:
● lived with you: 5
● didn't live with you due to divorce or separation:
No. of other dependents listed on 6c:

d If your child didn't live with you but is your dependent under a pre-1985 agreement, check here ▶ ☐
e Total number of exemptions claimed
Add numbers entered on lines above ▶ 7

Income

Please attach Copy B of your Forms W-2, W-2G, and W-2P here.

If you do not have a W-2, see page 6 of Instructions.

Please attach check or money order here.

7	Wages, salaries, tips, etc. (attach Form(s) W-2)	7	
8a	Taxable interest income (also attach Schedule B if over $400)	8a	
b	Tax-exempt interest income (page 11). DON'T include on line 8a 8b		
9	Dividend income (also attach Schedule B if over $400)	9	
10	Taxable refunds of state and local income taxes, if any, from worksheet on page 11 of Instructions	10	
11	Alimony received	11	
12	Business income or (loss)(attach Schedule C)	12	
13	Capital gain or (loss)(attach Schedule D)	13	2579
14	Capital gain distributions not reported on line 13 (see page 11)	14	
15	Other gains or (losses)(attach Form 4797)	15	
16a	Total IRA distributions 16a , 16b Taxable amount (pg. 11)	16b	
17a	Total pensions and annuities 17a , 17b Taxable amount (pg. 12)	17b	
18	Rents, royalties, partnerships, estates, trusts, etc. (attach Schedule E)	18	
19	Farm income or (loss)(attach Schedule F)	19	37000
20	Unemployment compensation (insurance)(see page 13)	20	
21a	Social security benefits (see page 13) 21a		
b	Taxable amount, if any, from the worksheet on page 13	21b	
22	Other income	22	
23	Add the amounts shown in the far right column for lines 7 through 22. This is your total income ▶	23	39579

Adjustments to Income

(See Instructions on page 13.)

24	Reimbursed employee business expenses from Form 2106, line 13	24	
25a	Your IRA deduction, from applicable worksheet on page 14 or 15	25a	
b	Spouse's IRA deduction, from applicable worksheet on page 14/15	25b	
26	Self-employed health insurance deduction from worksheet, pg. 15	26	
27	Keogh retirement plan and self-employed SEP deduction	27	
28	Penalty on early withdrawal of savings	28	
29	Alimony paid (recipient's last name: and social security number:)	29	
30	Add lines 24 through 29. These are your total adjustments ▶	30	0

Adjusted Gross Income

31	Subtract line 30 from line 23. This is your adjusted gross income. If this line is less than $18,576 and a child lived with you, see "Earned Income Credit" (line 56) on page 18 of the Instructions. If you want IRS to figure your tax, see page 16 of the Instructions. ▶	31	39579

without Capital Gains

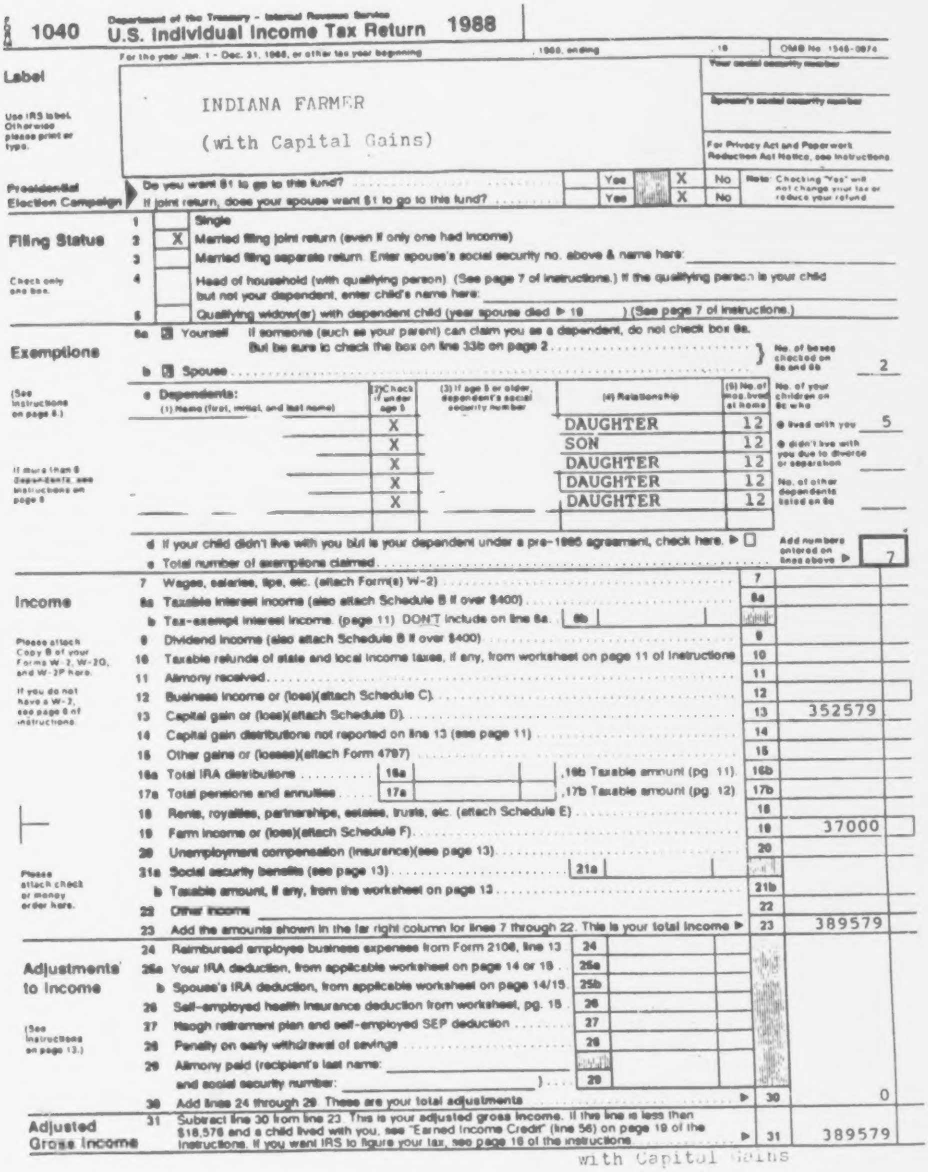
Form 1040 (1988) Page 2

	32	Amount from line 31 (adjusted gross income)			32	39579
Tax Computation	33a	Check if: ☐ You were 65 or over ☐ Blind; ☐ Spouse was 65 or over ☐ Blind. Add the number of boxes checked and enter the total here ▶	33a			
	b	If someone (such as your parent) can claim you as a dependent, check here ▶	33b ☐			
	c	If you are married filing a separate return and your spouse itemizes deductions, or you are a dual-status alien, see page 16 and check here ▶	33c ☐			
	34	Enter the larger of: • Your **standard deduction** (from page 17 of the instructions), OR • Your **itemized deductions** (from Schedule A, line 26). If you itemize, attach Schedule A and check here ▶ ☐			34	5000
	35	Subtract line 34 from line 32. Enter the result here			35	34579
	36	Multiply $1,950 by the total number of exemptions claimed on line 6e			36	13650
	37	**Taxable income.** Subtract line 36 from line 35. Enter the result (if less than zero, enter zero)			37	20929
		Caution: If under age 14 and you have more than $1,000 of investment income, check here ▶ ☐ and see page 17 to see if you have to use Form 8615 to figure your tax.				
	38	Enter tax. Check if from: ☒ Tax Table, ☐ Tax Rate Schedules, or ☐ Form 8615			38	3139
	39	Additional taxes (see page 17). Check if from: ☐ Form 4970, or ☐ Form 4972			39	
	40	Add lines 38 and 39. Enter the total ▶			40	3139
Credits	41	Credit for child and dependent care expenses (attach Fm 2441)	41			
	42	Credit for the elderly or the disabled (attach Schedule R)	42			
	43	Foreign tax credit (attach Form 1116)	43			
(See instructions on page 18.)	44	General business credit. Check if from: ☒ Form 3800 or ☐ Form (specify) ______	44	1513		
	45	Credit for prior year minimum tax (attach Form 8801)	45			
	46	Add lines 41 through 45			46	1513
	47	Subtract line 46 from line 40. Enter the result (if less than zero, enter zero) ▶			47	1626
Other Taxes	48	Self-employment tax (attach Schedule SE)			48	4817
	49	Alternative minimum tax (attach Form 6251)			49	
(Including Advance EIC Payments)	50	Recapture taxes (see page 18). Check if from: ☐ Form 4255, or ☐ Form 8611			50	
	51	Social security tax on tip income not reported to employer (attach Form 4137)			51	
	52	Tax on an IRA or a qualified retirement plan (attach Form 5329)			52	
	53	Add lines 47 through 52. This is your **total tax** ▶			53	6443
Payments	54	Federal income tax withheld (if any is from Form(s) 1099, check ▶ ☐)	54			
	55	1988 estimated tax payments and amount applied from 1987 return	55			
	56	Earned income credit	56			
Attach Forms W-2, W-2G, and W-2P to front.	57	Amount paid with Form 4868 (extension request)	57			
	58	Excess social security tax and RRTA tax withheld (see page 20)	58			
	59	Credit for Federal tax on fuels (attach Form 4136)	59	586		
	60	Regulated investment company credit	60			
	61	Add lines 54 through 60. These are your **total payments** ▶			61	586
Refund or Amount You Owe	62	If line 61 is larger than line 53, enter amount **OVERPAID** ▶			62	
	63	Amount of line 62 to be **REFUNDED TO YOU** ▶			63	
	64	Amount of line 62 to be applied to your 1989 estimated tax ▶	64			
	65	If line 53 is larger than line 61, enter **AMOUNT YOU OWE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number, daytime phone number, and "1988 Form 1040" on it			65	5857
		Check ▶ ☐ if Form 2210 (2210F) is attached. See page 21. Penalty: $				

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Please Sign Here	▶ Your signature	Date	Your occupation FARMER	
	▶ Spouse's signature (if joint return, BOTH must sign)	Date	Spouse's occupation HOUSEWIFE	
Paid Preparer's Use Only	Preparer's signature ▶ Sharon K. Watkins	Date	Check if self-employed ☐	Preparer's social security no. 317-46-0263
	Firm's name (or yours if self-employed) and address ▶ WATKINS ACCOUNTING SERVICE ROUTE 1 BOX 407 LEXINGTON, IN			E.I. No. 35-1495833 ZIP Code 47138

Exhibit 1A



1040 Department of the Treasury - Internal Revenue Service
U.S. Individual Income Tax Return 1988

For the year Jan. 1 - Dec. 31, 1988, or other tax year beginning , 1988, ending , 19 OMB No. 1545-0074

Label

Use IRS label. Otherwise please print or type.

INDIANA FARMER

(with Capital Gains)

Your social security number

Spouse's social security number

For Privacy Act and Paperwork Reduction Act Notice, see Instructions.

Presidential Election Campaign

Do you want $1 to go to this fund?	☐	Yes	X	No	Note: Checking "Yes" will not change your tax or reduce your refund.
If joint return, does your spouse want $1 to go to this fund?	☐	Yes	X	No	

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above & name here: ______
4 ☐ Head of household (with qualifying person). (See page 7 of instructions.) If the qualifying person is your child but not your dependent, enter child's name here: ______
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19) (See page 7 of instructions.)

Exemptions

(See instructions on page 8.)

6a ☒ Yourself If someone (such as your parent) can claim you as a dependent, do not check box 6a. But be sure to check the box on line 33b on page 2.
b ☒ Spouse

No. of boxes checked on 6a and 6b: 2

c Dependents:

(1) Name (first, initial, and last name)	(2) Check if under age 5	(3) If age 5 or older, dependent's social security number	(4) Relationship	(5) No. of mos. lived at home
	X		DAUGHTER	12
	X		SON	12
	X		DAUGHTER	12
	X		DAUGHTER	12
	X		DAUGHTER	12

If more than 6 dependents, see instructions on page 8.

No. of your children on 6c who:
● lived with you 5
● didn't live with you due to divorce or separation ______
No. of other dependents listed on 6c ______

d If your child didn't live with you but is your dependent under a pre-1985 agreement, check here. ▶ ☐
e Total number of exemptions claimed

Add numbers entered on lines above ▶ 7

Income

Please attach Copy B of your Forms W-2, W-2G, and W-2P here.

If you do not have a W-2, see page 6 of instructions.

Please attach check or money order here.

7	Wages, salaries, tips, etc. (attach Form(s) W-2)	7	
8a	Taxable interest income (also attach Schedule B if over $400)	8a	
b	Tax-exempt interest income (page 11). DON'T include on line 8a. 8b		
9	Dividend income (also attach Schedule B if over $400)	9	
10	Taxable refunds of state and local income taxes, if any, from worksheet on page 11 of Instructions	10	
11	Alimony received	11	
12	Business income or (loss)(attach Schedule C)	12	
13	Capital gain or (loss)(attach Schedule D)	13	352579
14	Capital gain distributions not reported on line 13 (see page 11)	14	
15	Other gains or (losses)(attach Form 4797)	15	
16a	Total IRA distributions 16a , 16b Taxable amount (pg. 11)	16b	
17a	Total pensions and annuities 17a , 17b Taxable amount (pg. 12)	17b	
18	Rents, royalties, partnerships, estates, trusts, etc. (attach Schedule E)	18	
19	Farm income or (loss)(attach Schedule F)	19	37000
20	Unemployment compensation (insurance)(see page 13)	20	
21a	Social security benefits (see page 13) 21a		
b	Taxable amount, if any, from the worksheet on page 13	21b	
22	Other income	22	
23	Add the amounts shown in the far right column for lines 7 through 22. This is your total income ▶	23	389579

Adjustments to Income

(See instructions on page 13.)

24	Reimbursed employee business expenses from Form 2106, line 13	24	
25a	Your IRA deduction, from applicable worksheet on page 14 or 15	25a	
b	Spouse's IRA deduction, from applicable worksheet on page 14/15	25b	
26	Self-employed health insurance deduction from worksheet, pg. 15	26	
27	Keogh retirement plan and self-employed SEP deduction	27	
28	Penalty on early withdrawal of savings	28	
29	Alimony paid (recipient's last name: ______ and social security number: ______)	29	
30	Add lines 24 through 29. These are your total adjustments ▶	30	0

Adjusted Gross Income

31	Subtract line 30 from line 23. This is your adjusted gross income. If this line is less than $18,576 and a child lived with you, see "Earned Income Credit" (line 56) on page 19 of the instructions. If you want IRS to figure your tax, see page 16 of the instructions ▶	31	389579

with Capital Gains

Form 1040 (1988) Page 2

Tax Computation	32	Amount from line 31 (adjusted gross income)			32	389579
	33a	Check if: ☐ You were 65 or over ☐ Blind; ☐ Spouse was 65 or over ☐ Blind. Add the number of boxes checked and enter the total here ▶	33a			
	b	If someone (such as your parent) can claim you as a dependent, check here ▶	33b ☐			
	c	If you are married filing a separate return and your spouse itemizes deductions, or you are a dual-status alien, see page 16 and check here ▶	33c ☐			
	34	Enter the larger of: { • Your standard deduction (from page 17 of the instructions), OR • Your itemized deductions (from Schedule A, line 26) If you itemize, attach Schedule A and check here ▶ ☐ }			34	5000
	35	Subtract line 34 from line 32. Enter the result here.			35	384579
	36	Multiply $1,950 by the total number of exemptions claimed on line 6e			36	13650
	37	**Taxable income.** Subtract line 36 from line 35. Enter the result (if less than zero, enter zero).			37	370929
		Caution: If under age 14 and you have more than $1,000 of investment income, check here ▶ ☐ and see page 17 to see if you have to use Form 8615 to figure your tax.				
	38	Enter tax. Check if from: ☐ Tax Table, ☒ Tax Rate Schedules, or ☐ Form 8615			38	107682
	39	Additional taxes (see page 17). Check if from: ☐ Form 4970, or ☐ Form 4972			39	
		dd lines 38 and 39. Enter the total ▶			40	107682
Credits (See Instructions on page 18.)		redit for child and dependent care expenses (attach Fm 2441)	41			
		Credit for the elderly or the disabled (attach Schedule R)	42			
	43	Foreign tax credit (attach Form 1116)	43			
	44	General business credit. Check if from: ☒ Form 3800 or ☐ Form (specify) ______	44	1513		
	45	Credit for prior year minimum tax (attach Form 8801)	45			
	46	Add lines 41 through 45.			46	1513
	47	Subtract line 46 from line 40. Enter the result (if less than zero, enter zero) ▶			47	106169
Other Taxes (Including Advance EIC Payments)	48	Self-employment tax (attach Schedule SE)			48	4817
	49	Alternative minimum tax (attach Form 6251)			49	
	50	Recapture taxes (see page 18). Check if from: ☐ Form 4255, or ☐ Form 8611			50	
	51	Social security tax on tip income not reported to employer (attach Form 4137)			51	
	52	Tax on an IRA or a qualified retirement plan (attach Form 5329)			52	
	53	Add lines 47 through 52. This is your **total tax** ▶			53	110986
Payments Attach Forms W-2, W-2G, and W-2P to front.	54	Federal income tax withheld (if any is from Form(s) 1099, check ▶ ☐)	54			
	55	1988 estimated tax payments and amount applied from 1987 return	55			
	56	Earned income credit	56			
	57	Amount paid with Form 4868 (extension request)	57			
	58	Excess social security tax and RRTA tax withheld (see page 20)	58			
	59	Credit for Federal tax on fuels (attach Form 4136)	59	586		
	60	Regulated investment company credit	60			
	61	Add lines 54 through 60. These are your **total payments** ▶			61	586
Refund or Amount You Owe	62	If line 61 is larger than line 53, enter amount OVERPAID ▶			62	
	63	Amount of line 62 to be **REFUNDED TO YOU** ▶			63	
	64	Amount of line 62 to be applied to your 1989 estimated tax ▶	64			
	65	If line 53 is larger than line 61, enter **AMOUNT YOU OWE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write your social security number, daytime phone number, and "1988 Form 1040" on it. Check ▶ ☐ if Form 2210 (2210F) is attached. See page 21. Penalty: $			65	110400

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Please Sign Here	▶ Your signature	Date	Your occupation FARMER
	▶ Spouse's signature (if joint return, BOTH must sign)	Date	Spouse's occupation HOUSEWIFE
Paid Preparer's Use Only	Preparer's signature ▶ Sharon K. Watkins	Date	Check if self-employed ☐ | Preparer's social security no. 317-46-0263
	Firm's name (or yours if self-employed) and address ▶ WATKINS ACCOUNTING SERVICE ROUTE 1 BOX 407 LEXINGTON, IN		E.I. No. 35-1495833 ZIP Code 47138

Form **6251**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax – Individuals

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1040NR. Estates and trusts, use Form 8656.

OMB No. 1545-0227

1988

Attachment Sequence No. 32

1	Taxable income from Form 1040, line 37 (can be less than zero)			1	247188
2	Net operating loss deduction (Do not enter as a negative amount)			2	123741
3	Add lines 1 and 2			3	370929
4	**Adjustments:** (See line-by-line instructions before completing.)				
a	Standard deduction from Form 1040, line 34	4a	5000		
b	Personal exemption amount from Form 1040, line 36	4b	13650		
c	Medical and dental expense	4c			
d	Miscellaneous itemized deductions from Schedule A, line 24	4d			
e	Taxes from Schedule A, line 8	4e			
f	Refund of taxes	4f	( )		
g	Interest from Schedule A, line 12b	4g			
h	Other interest adjustments	4h			
i	Combine lines 4a through 4h			4i	18650
j	Depreciation of property placed in service after 1986	4j			
k	Circulation and research and experimental expenditures paid or incurred after 1986	4k			
l	Mining exploration and development costs paid or incurred after 1986	4l			
m	Long-term contracts entered into after 2/28/86	4m			
n	Pollution control facilities placed in service after 1986	4n			
o	Installment sales of certain property	4o			
p	Adjusted gain or loss	4p			
q	Certain loss limitations	4q			
r	Tax shelter farm loss	4r			
s	Passive activity loss	4s			
t	Beneficiaries of estates and trusts	4t			
u	Combine lines 4j through 4t			4u	
5	**Tax preference items:** (See line-by-line instructions before completing.)				
a	Appreciated property charitable deduction	5a			
b	Tax-exempt interest from private activity bonds issued after August 7, 1986	5b			
c	Depletion	5c			
d	Add lines 5a through 5c			5d	
e	Accelerated depreciation of real property placed in service before 1987	5e			
f	Accelerated depreciation of leased personal property placed in service before 1987	5f			
g	Amortization of certified pollution control facilities placed in service before 1987	5g			
h	Incentive stock options. See instructions	5h			
i	Intangible drilling costs	5i			
j	Reserves for losses on bad debts of financial institutions	5j			
k	Add lines 5e through 5j			5k	
6	Combine lines 3, 4i, 4u, 5d, and 5k			6	389579
	Alternative tax net operating loss deduction (Do not enter more than 90% of line 6.) See instructions			7	
8	Alternative minimum taxable income (subtract line 7 from line 6) If married filing separate returns, see instructions			8	389579
9	Enter: $40,000 ($20,000 if married filing separately; $30,000 if single or head of household)			9	40000
10	Enter: $150,000 ($75,000 if married filing separately; $112,500 if single or head of household)			10	150000
11	Subtract line 10 from line 8. If –0– or less, enter –0– here and on line 12 and go to line 13. If this line is more than –0–, go to line 12.			11	239579
12	Multiply line 11 by 25% (.25)			12	59895
13	Subtract line 12 from line 9. If –0– or less, enter –0–			13	0
14	Subtract line 13 from line 8. If –0– or less, enter –0– here and on line 19. If this line is more than –0–, go to line 15.			14	389579
15	Multiply line 14 by 21% (.21)			15	81812
16	Alternative minimum tax foreign tax credit. See instructions			16	
17	Tentative minimum tax (subtract line 16 from line 15)			17	81812
18	Regular tax before credits (Form 1040, line 38) minus foreign tax credit (Form 1040, line 43). See instructions			18	73035
19	Alternative minimum tax (subtract line 18 from 17). Enter on Form 1040, line 49. If -0- or less, enter -0-			19	8777

For Paperwork Reduction Act Notice, see separate instructions.

Form 6251 (1988)

SCHEDULE D
(Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

(And Reconciliation of Forms 1099-B)

▶ Attach to Form 1040. ▶ See instructions for Schedule D (Form 1040)

For Paperwork Reduction Act Notice, see Form 1040 Instructions

OMB No. 1545-0074

1988

Attachment Sequence No. 12

Name(s) as shown on Form 1040

Your social security number

1 Report here the total sales of stocks, bonds, etc., reported for 1988 by your broker to you on Form(s) 1099-B or an equivalent substitute statement(s). If this amount differs from the total of lines 2b and 9b, column (d), attach a statement explaining the difference. See the Instructions for line 1 for examples 1

Part I Short-term Capital Gains and Losses – Assets Held One Year or Less (6 months or less if acquired before 1/1/88)

(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see instructions)	(e) Cost or other basis, (see instructions)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
2a Stocks, Bonds, and Other Securities (Include all Form 1099-B transactions. See Instructions.)						
2b Total (add column (d)) . . . . 2b ▶						
2c Other Transactions (Include Real Estate Transactions From Forms 1099-S)						

			(f)	(g)
3	Short-term gain from sale or exchange of your home from Form 2119, lines 8a or 14	3		
4	Short-term gain from installment sales from Form 6252, lines 22 or 30	4		
5	Net short-term gain or (loss) from partnerships, S corporations, and fiduciaries	5		
6	Short-term capital loss carryover	6		
7	Add all of the transactions on lines 2a and 2c and lines 3 through 6 in columns (f) and (g)	7	( )	
8	Net short-term gain or (loss), combine columns (f) and (g) of line 7	8		

Part II Long-term Capital Gains and Losses – Assets Held More Than One Year (over 6 months if acquired before 1/1/88)

(a) Description of property	(b) Date acquired	(c) Date sold	(d) Sales price	(e) Cost or other basis	(f) LOSS	(g) GAIN
9a Stocks, Bonds, and Other Securities (Include all Form 1099-B transactions. See Instructions.)						
9b Total (add column (d)) . . . . 9b ▶						
9c Other Transactions (Include Real Estate Transactions From Forms 1099-S)						
BROOD SOWS (8)	1/01/86	7/01/88	2579			2579

			(f)	(g)
10	Long-term gain from sale or exchange of your home from Form 2119, lines 8a, 10, or 14	10		
11	Long-term gain from installment sales from Form 6252, lines 22 or 30	11		
12	Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries	12		
13	Capital gain distributions	13		
14	Enter gain from Form 4797, line 7 or 9	14		350000
15	Long-term capital loss carryover	15		
16	Add all of the transactions on lines 9a and 9c and lines 10 through 15 in columns (f) and (g)	16	( )	352579
17	Net long-term gain or (loss), combine columns (f) and (g) of line 16	17		352579

S. K. Watkins
Testimony before Subcommittee
on Energy and Agricultural Taxation

INDIANA FARMER
EQUITY ANALYSIS
AS OF 12-31-88

ASSET	INDEBTEDNESS OF ASSET	FAIR MARKET VALUE OF ASSET	EQUITY
Cash	-0-	$ 75,000.00	$75,000.00
Equipment	-0-	25,000.00	25,000.00
Farm #1	$100,000.00	100,000.00	-0-
Farm #2	150,000.00	100,000.00	-0-
	$250,000.00	$300,000.00	$100,000.00

INDIANA FARMER
NET WORTH BALANCE SHEET
AS OF 12-31-88

ASSETS	FAIR MARKET VALUE	LIABILITIES	AMOUNT
Short Term		Short Term	$ -0-
Cash	$ 75,000.00		
Intermediate		Intermediate	-0-
Equipment	25,000.00		
Long Term		Long Term	
Farm #1	100,000.00	FLB	100,000.00
Farm #2	100,000.00	Bank	150,000.00
TOTAL ASSETS	$300,000.00	TOTAL LIABILITIES	$250,000.00
		TOTAL NET WORTH	50,000.00
		TOTAL LIABILITIES AND NET WORTH	$300,000.00

THE EQUITY ANALYSIS SHOWS A TOTAL EQUITY OF $100,000.00 AND THE NET WORTH BALANCE SHEET SHOWS A TOTAL NET WORTH OF $50,000.00.

EXHIBIT 2

CASH FLOW STATEMENT

Exhibit 3

NAME: INDIANA FARMER
ADDRESS: KENT, INDIANA
PROJECTED FOR 1988
PHONE: 000-000-0000
DATE: 07/23/89
PAGE 1

PROFIT CENTER: NOT DEFINED

DESCRIPTION	LAST YR	TOTAL	JAN.	FEB.	MARCH	APRIL	MAY	JUNE	JULY	AUGUST	SEPT	OCT.	NOV.	DEC.
BEG. CASH BALANCE	0	75000	75000	71842	66021	62863	30768	26485	24202	21919	19636	17353	11570	8287
OPERATING RECEIPTS:														
CROPS AND FEED	0	112007	0	0	0	0	0	0	0	0	0	0	0	112007
LIVESTOCK & POULTRY	0	0	0	0	0	0	0	0	0	0	0	0	0	0
PRODUCTS (LIVESTOCK)	0	0	0	0	0	0	0	0	0	0	0	0	0	0
CUSTOM WORK	0	0	0	0	0	0	0	0	0	0	0	0	0	0
GOVERNMENT PAYMENTS	0	0	0	0	0	0	0	0	0	0	0	0	0	0
HEDGING ACCOUNT W/D	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
CAPITAL RECEIPTS:														
BREEDING STOCK	0	0	0	0	0	0	0	0	0	0	0	0	0	0
MACHINERY & EQUIP.	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
NON-FARM INCOME:														
OFF-FARM WAGES	0	0	0	0	0	0	0	0	0	0	0	0	0	0
INTEREST & DIVIDENDS	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
TOTAL CASH AVAILABLE	0	187007	75000	71842	66021	62863	30768	26485	24202	21919	19636	17353	11570	120294
OPERATING EXPENSES:														
LABOR HIRED	0	1000	0	0	0	500	0	0	0	0	0	500	0	0
REPAIRS-MACH & EQUIP	0	3500	875	875	875	875	0	0	0	0	0	0	0	0
REPAIRS-BUILD/IMPROV	0	0	0	0	0	0	0	0	0	0	0	0	0	0
RENTS & LEASES	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SEED	0	9538	0	0	0	9538	0	0	0	0	0	0	0	0
FERTILIZER & LIME	0	14152	0	0	0	14152	0	0	0	0	0	0	0	0
CHEMICALS	0	2747	0	0	0	2747	0	0	0	0	0	0	0	0
CUSTOM MACHINE HIRE	0	0	0	0	0	0	0	0	0	0	0	0	0	0
SUPPLIES	0	500	0	0	0	500	0	0	0	0	0	0	0	0
LIVESTOCK EXPENSE	0	0	0	0	0	0	0	0	0	0	0	0	0	0
GAS, FUEL, OIL	0	3500	0	0	0	1000	1000	0	0	0	0	1500	0	0
STORAGE/CUSTOM DRY	0	0	0	0	0	0	0	0	0	0	0	0	0	0
TAXES (REAL EST, PP)	0	2000	0	0	0	0	1000	0	0	0	0	0	1000	0
INSURANCE(PROP,LIAB)	0	1000	0	0	0	500	0	0	0	0	0	500	0	0
UTILITIES(ELECT/GAS)	0	2200	100	100	100	100	100	100	100	100	100	1100	100	100
MARKET/TRANSPORT EXP	0	1000	0	0	0	0	0	0	0	0	0	0	0	1000
AUTO (FARM SHARE)	0	1200	100	100	100	100	100	100	100	100	100	100	100	100
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
TOTAL CASH OPER EXPS	0	42337	1075	1075	1075	30012	2200	200	200	200	200	3700	1200	1200

CASH FLOW STATEMENT

NAME: INDIANA FARMER
PROJECTED FOR 1988
ADDRESS: KENT, INDIANA
PHONE: 000-000-0000
DATE: 07/23/89
PAGE 2

PROFIT CENTER: NOT DEFINED

DESCRIPTION	LAST YR	TOTAL	JAN.	FEB.	MARCH	APRIL	MAY	JUNE	JULY	AUGUST	SEPT	OCT.	NOV.	DEC.
STOCK & FEED PURCH:														
FEEDER LIVESTOCK	0	0	0	0	0	0	0	0	0	0	0	0	0	0
BREEDING LIVESTOCK	0	0	0	0	0	0	0	0	0	0	0	0	0	0
FEED PURCHASED	0	0	0	0	0	0	0	0	0	0	0	0	0	0
CAPITAL EXPENDITURES														
MACHINERY & EQUIP	0	0	0	0	0	0	0	0	0	0	0	0	0	0
BUILDINGS & IMPROVE.	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
OTHER EXPENDITURES:														
HEDGING ACCT DEPOSIT	0	0	0	0	0	0	0	0	0	0	0	0	0	0
GROSS FAMILY LIV W/D	0	24996	2083	2083	2083	2083	2083	2083	2083	2083	2083	2083	2083	2083
NON-FARM BUS/INVEST	0	0	0	0	0	0	0	0	0	0	0	0	0	0
INCOME TAX & SOC SEC	0	2663	0	2663	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0	0	0	0	0
LOAN PAYMENTS - PRIN	0	12500	0	0	0	0	0	0	0	0	0	0	0	12500
LOAN PAYMENTS - INT	0	29500	0	0	0	0	0	0	0	0	0	0	0	29500
TOTAL CASH REQUIRED	0	111996	3158	5821	3158	32095	4283	2283	2283	2283	2283	5783	3283	45283
CASH AVAIL -CASH REQ		75011	71842	66021	62863	30768	26485	24202	21919	19636	17353	11570	8287	75011
INFLOWS FROM SAVINGS		0	0	0	0	0	0	0	0	0	0	0	0	0
CASH POS BEFORE BORR		75011	71842	66021	62863	30768	26485	24202	21919	19636	17353	11570	8287	75011
MONEY TO BE BORROWED														
- OPERATING LOANS		0	0	0	0	0	0	0	0	0	0	0	0	0
- INT & L/T LOANS		0	0	0	0	0	0	0	0	0	0	0	0	0
OP LOAN PAY - PRIN		0	0	0	0	0	0	0	0	0	0	0	0	0
- INTEREST		0	0	0	0	0	0	0	0	0	0	0	0	0
OUTFLOWS TO SAVINGS		0	0	0	0	0	0	0	0	0	0	0	0	0
ENDING CASH BALANCE		75011	71842	66021	62863	30768	26485	24202	21919	19636	17353	11570	8287	75011
LOAN BALANCES:														
CURR INTEREST RATE	.00													
CURRENT YR'S OP LOAN			0	0	0	0	0	0	0	0	0	0	0	0
- ACCRUED INTEREST			0	0	0	0	0	0	0	0	0	0	0	0
PREV YR'S OPER LOANS			0	0	0	0	0	0	0	0	0	0	0	0
- ACCRUED INTEREST			0	0	0	0	0	0	0	0	0	0	0	0
INT & LONG TERM LOAN	250000		250000	250000	250000	250000	250000	250000	250000	250000	250000	250000	250000	237500
TOTAL LOANS			250000	250000	250000	250000	250000	250000	250000	250000	250000	250000	250000	237500
CONSISTENCY CHECK:														
TOTAL INFLOWS			75000	71842	66021	62863	30768	26485	24202	21919	19636	17353	11570	120294
TOTAL OUTFLOWS			75000	71842	66021	62863	30768	26485	24202	21919	19636	17353	11570	120294
BUDGETING ERROR			0	0	0	0	0	0	0	0	0	0	0	0

BALANCE SHEET

NAME: INDIANA FARMER
ACTUAL FOR 1988
ADDRESS: KENT, INDIANA
PHONE: 000-000-0000 UPDATED THRU: 12/31/88 DATE: 07/23/89

PROFIT CENTER: NOT DEFINED

ASSETS

CURRENT ASSETS		MOD COST	MKT VALUE
Cash (on hand) or in checking		75,000	75,000
Savings accounts & time certificates		0	0
Hedging account equity		0	0
Marketable bonds & securities (Sch 1)		0	0
Accounts receivable (Sch AR)		0	0
Notes receivable (Sch NR)		0	0
Livestock & poultry to be sold (Sch LS)		0	0
Crops and feed (Sch CF)		0	0
Cash investment in growing crops (Sch CI)		0	0
Supplies (Sch 2)		0	0
Prepaid expenses		0	0
Other (tax refund, ect.)		0	0
TOTAL CURRENT ASSETS		75,000	75,000
INTERMEDIATE ASSETS			
Accounts receivable (Sch AR)		0	0
Notes receivable (Sch NR)		0	0
Machinery, equipment, trucks (Sch 9)			25,000
Cost or Basis	25,000		
Less accumulated dep	0	25,000	
Breeding stock (Sch 4)		0	0
Retirement accounts		0	0
Cash value of life insurance (Sch 7)		0	0
Securities not readily marketable(Sch 1)		0	0
Personal vehicles/household goods(Sch 3)		0	0
Other		0	0
TOTAL INTERMEDIATE ASSETS		25,000	25,000
FIXED ASSETS			
Contracts & notes receivable (Sch NR)		0	0
Farm real estate (Sch 5)			200,000
Cost or Basis	100,000		
Less accumulated dep	0	100,000	
Non-farm real estate (Sch 6)		0	0
Other		0	0
TOTAL FIXED ASSETS		100,000	200,000
TOTAL ASSETS		200,000	300,000

LIABILITIES AND NET WORTH

CURRENT LIABILITIES		MOD COST	MKT VALUE
Accounts payable (Sch AP)		0	0
Medical and other personal		0	0
Notes payable (Sch NP)		0	0
Principal part of long term debts (Sch 8)			
Intermediate		0	0
Long Term		12,500	12,500
Estimated accrued interest on			
Accounts 0 Notes	0		
Intermediate liabilities	0		
Long term liabilities	0	0	0
Estimated accrued tax liability:			
Property		0	0
Real estate		0	0
Employer payroll withholdings		0	0
Income & social security		0	0
Accrued rents & lease payments (Sch 5b)		0	0
Other (including relatives)		0	0
Contingent income tax liability:			
Current assets			0
Marketable securities			0
TOTAL CURRENT LIABILITIES		12,500	12,500
INTERMEDIATE LIABILITIES			
(Principal due beyond 12 months)			
Notes payable		0	0
Sales contracts		0	0
Life insurance policy loans		0	0
Other		0	0
Contingent income tax liability:			
Machinery			0
Breeding stock			0
Securities not readily marketable			0
Contingent income tax liability &			
interest penalty on retirement accts			0
TOTAL INTERMEDIATE LIABILITIES		0	0
LONG TERM LIABILITIES (Sch 8)			
(Principal due beyond 12 months)			
Mortgage on farm real estate		237,500	237,500
Land contracts		0	0
Mortgage on non-farm real estate		0	0
Other			0
Contingent capital gains tax liability:			
Real estate			0
TOTAL LONG TERM LIABILITIES		237,500	237,500
TOTAL LIABILITIES		250,000	250,000
NET WORTH		50,000-	50,000
TOTAL LIABILITIES AND NET WORTH		200,000	300,000

1-1-88

BALANCE SHEET

NAME: INDIANA FARMER
ACTUAL FOR 1988
ADDRESS: KENT, INDIANA
PHONE: 000-000-0000 UPDATED THRU: 12/31/88 DATE: 07/23/89

PROFIT CENTER: NOT DEFINED

ASSETS

CURRENT ASSETS		MOD COST	MKT VALUE
Cash (on hand) or in checking		62,863	62,863
Savings accounts & time certificates		0	0
Hedging account equity		0	0
Marketable bonds & securities (Sch 1)		0	0
Accounts receivable (Sch AR)		0	0
Notes receivable (Sch NR)		0	0
Livestock & poultry to be sold (Sch LS)		0	0
Crops and feed (Sch CF)		0	0
Cash investment in growing crops (Sch CI)		0	0
Supplies (Sch 2)		0	0
Prepaid expenses		0	0
Other (tax refund, ect.)		0	0
TOTAL CURRENT ASSETS		62,863	62,863
INTERMEDIATE ASSETS			
Accounts receivable (Sch AR)		0	0
Notes receivable (Sch NR)		0	0
Machinery, equipment, trucks (Sch 9)			25,000
Cost or Basis	25,000		
Less accumulated dep	0	25,000	
Breeding stock (Sch 4)		0	0
Retirement accounts		0	0
Cash value of life insurance (Sch 7)		0	0
Securities not readily marketable(Sch 1)		0	0
Personal vehicles/household goods(Sch 3)		0	0
Other		0	0
TOTAL INTERMEDIATE ASSETS		25,000	25,000
FIXED ASSETS			
Contracts & notes receivable (Sch NR)		0	0
Farm real estate (Sch 5)			200,000
Cost or Basis	100,000		
Less accumulated dep	0	100,000	
Non-farm real estate (Sch 6)		0	0
Other		0	0
TOTAL FIXED ASSETS		100,000	200,000
TOTAL ASSETS		187,863	287,863

LIABILITIES AND NET WORTH

CURRENT LIABILITIES		MOD COST	MKT VALUE
Accounts payable (Sch AP)		0	0
Medical and other personal		0	0
Notes payable (Sch NP)		0	0
Principal part of long term debts (Sch 8)			
Intermediate		0	0
Long Term		12,500	12,500
Estimated accrued interest on			
Accounts 0 Notes	0		
Intermediate liabilities	0		
Long term liabilities	7,375	7,375	7,375
Estimated accrued tax liability:			
Property		0	0
Real estate		0	0
Employer payroll withholdings		0	0
Income & social security		0	0
Accrued rents & lease payments (Sch 5b)		0	0
Other (including relatives)		0	0
Contingent income tax liability:			
Current assets			0
Marketable securities			0
TOTAL CURRENT LIABILITIES		19,875	19,875
INTERMEDIATE LIABILITIES			
(Principal due beyond 12 months)			
Notes payable		0	0
Sales contracts		0	0
Life insurance policy loans		0	0
Other		0	0
Contingent income tax liability:			
Machinery			0
Breeding stock			0
Securities not readily marketable			0
Contingent income tax liability & interest penalty on retirement accts			0
TOTAL INTERMEDIATE LIABILITIES		0	0
LONG TERM LIABILITIES (Sch			
(Principal due beyond 12 months)			
Mortgage on farm real estate		237,500	237,500
Land contracts		0	0
Mortgage on non-farm real estate		0	0
Other		0	0
Contingent capital gains tax liability:			
Real estate			0
TOTAL LONG TERM LIABILITIES		237,500	237,500
TOTAL LIABILITIES		257,375	257,375
NET WORTH		69,512-	30,488
TOTAL LIABILITIES AND NET WORTH		187,863	287,863

4-1-88

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                                              B A L A N C E   S H E E T
                                                     ACTUAL FOR 1988
NAME:    INDIANA FARMER
ADDRESS:                         KENT, INDIANA         PHONE:  000-000-0000    UPDATED THRU: 12/31/88     DATE:  07/23/89
=========================================================================================================================
PROFIT CENTER: NOT DEFINED

                        ASSETS                                           LIABILITIES AND NET WORTH
---------------------------------------------------------  -------------------------------------------------------------
                                        MOD  COST  MKT VALUE  CURRENT LIABILITIES                          MOD  COST  MKT VALUE
CURRENT ASSETS                                                Accounts payable (Sch AP)                           0          0
Cash (on hand) or  in checking            24,202     24,202   Medical and other personal                          0          0
Savings accounts & time certificates           0          0   Notes payable (Sch NP)                              0          0
Hedging account equity                         0          0   Principal part of long term debts (Sch 8)
Marketable bonds & securities (Sch 1)          0          0     Intermediate                                      0          0
Accounts receivable (Sch AR)                   0          0     Long Term                                    12,500     12,500
Notes receivable (Sch NR)                      0          0   Estimated accrued interest on
Livestock & poultry to be sold (Sch LS)        0          0     Accounts          0   Notes          0
Crops and feed (Sch CF)                        0          0     Intermediate liabilities             0
Cash investment in growing crops (Sch CI) 26,435     26,435     Long term liabilities           14,750   14,750     14,750
Supplies (Sch 2)                               0          0   Estimated accrued tax liability:
Prepaid expenses                               0          0     Property                                          0          0
Other (tax refund, ect.)                       0          0     Real estate                                       0          0
                                                                Employer payroll withholdings                     0          0
                                                                Income & social security                          0          0
                                                              Accrued rents & lease payments (Sch 5b)             0          0
                                                              Other (including relatives)                         0          0
                                                              Contingent income tax liability:
                                                                Current assets                                               0
                                                                Marketable securities                                        0
         TOTAL CURRENT ASSETS             50,637     50,637           TOTAL CURRENT LIABILITIES              27,250     27,250

 INTERMEDIATE ASSETS                                          INTERMEDIATE LIABILITIES
 Accounts receivable (Sch AR)                  0          0   (Principal due beyond 12 months)
 Notes receivable (Sch NR)                     0          0   Notes payable                                       0          0
 Machinery, equipment, trucks (Sch 9)                25,000   Sales contracts                                     0          0
   Cost or Basis                 25,000                       Life insurance policy loans                         0          0
   Less accumulated dep               0   25,000              Other                                               0          0
 Breeding stock (Sch 4)                        0          0   Contingent income tax liability:
 Retirement accounts                           0          0     Machinery                                                    0
 Cash value of life insurance (Sch 7)          0          0     Breeding stock                                               0
 Securities not readily marketable(Sch 1)      0          0     Securities not readily marketable                            0
 Personal vehicles/household goods(Sch 3)      0          0   Contingent income tax liability &
 Other                                         0          0   interest penalty on retirement accts                         0
         TOTAL INTERMEDIATE ASSETS        25,000     25,000           TOTAL INTERMEDIATE LIABILITIES              0          0


                                                              LONG TERM LIABILITIES (Sch 8)
 FIXED ASSETS                                                 (Principal due beyond 12 months)
 Contracts & notes receivable (Sch NR)         0          0   Mortgage on farm real estate                  237,500    237,500
 Farm real estate (Sch 5)                           200,000   Land contracts                                      0          0
   Cost or Basis                100,000                       Mortgage on non-farm real estate                    0          0
   Less accumulatec dep               0  100,000              Other                                               0          0
 Non-farm real estate (Sch 6)                  0          0   Contingent capital gains tax liability:
 Other                                         0          0     Real estate                                                  0
                                                                      TOTAL LONG TERM LIABILITIES       237,500    237,500
         TOTAL FIXED ASSETS              100,000    200,000                      TOTAL LIABILITIES       264,750    264,750
                                                                                        NET WORTH        89,113-    10,887
            TOTAL ASSETS                 175,637    275,637       TOTAL LIABILITIES AND NET WORTH       175,637    275,637
```

7-1-88

BALANCE SHEET

ACTUAL FOR 1988

NAME: INDIANA FARMER
ADDRESS: KENT, INDIANA
PHONE: 000-000-0000 UPDATED THRU: 12/31/88 DATE: 07/23/89

PROFIT CENTER: NOT DEFINED

ASSETS

CURRENT ASSETS		MOD COST	MKT VALUE
Cash (on hand) or in checking		17,353	17,353
Savings accounts & time certificates		0	0
Hedging account equity		0	0
Marketable bonds & securities (Sch 1)		0	0
Accounts receivable (Sch AR)		0	0
Notes receivable (Sch NR)		0	0
Livestock & poultry to be sold (Sch LS)		0	0
Crops and feed (Sch CF)		0	0
Cash investment in growing crops (Sch CI)		26,435	26,435
Supplies (Sch 2)		0	0
Prepaid expenses		0	0
Other (tax refund, ect.)		0	0
TOTAL CURRENT ASSETS		43,788	43,788
INTERMEDIATE ASSETS			
Accounts receivable (Sch AR)		0	0
Notes receivable (Sch NR)		0	0
Machinery, equipment, trucks (Sch 9)			25,000
Cost or Basis	25,000		
Less accumulated dep	0	25,000	
Breeding stock (Sch 4)		0	0
Retirement accounts		0	0
Cash value of life insurance (Sch 7)		0	0
Securities not readily marketable(Sch 1)		0	0
Personal vehicles/household goods(Sch 3)		0	0
Other		0	0
TOTAL INTERMEDIATE ASSETS		25,000	25,000
FIXED ASSETS			
Contracts & notes receivable (Sch NR)		0	0
Farm real estate (Sch 5)			200,000
Cost or Basis	100,000		
Less accumulated dep	0	100,000	
Non-farm real estate (Sch 6)		0	0
Other		0	0
TOTAL FIXED ASSETS		100,000	200,000
TOTAL ASSETS		168,788	268,788

LIABILITIES AND NET WORTH

CURRENT LIABILITIES		MOD COST	MKT VALUE
Accounts payable (Sch AP)		0	0
Medical and other personal		0	0
Notes payable (Sch NP)		0	0
Principal part of long term debts (Sch 8)			
Intermediate		0	0
Long Term		12,500	12,500
Estimated accrued interest on			
Accounts 0 Notes	0		
Intermediate liabilities	0		
Long term liabilities	22,125	22,125	22,125
Estimated accrued tax liability:			
Property		0	0
Real estate		0	0
Employer payroll withholdings		0	0
Income & social security		0	0
Accrued rents & lease payments (Sch 5b)		0	0
Other (including relatives)		0	0
Contingent income tax liability:			
Current assets			0
Marketable securities			0
TOTAL CURRENT LIABILITIES		34,625	34,625
INTERMEDIATE LIABILITIES			
(Principal due beyond 12 months)			
Notes payable		0	0
Sales contracts		0	0
Life insurance policy loans		0	0
Other		0	0
Contingent income tax liability:			
Machinery			0
Breeding stock			0
Securities not readily marketable			0
Contingent income tax liability & interest penalty on retirement accts			0
TOTAL INTERMEDIATE LIABILITIES		0	0
LONG TERM LIABILITIES (Sch 8)			
(Principal due beyond 12 months)			
Mortgage on farm real estate		237,500	237,500
Land contracts		0	0
Mortgage on non-farm real estate		0	0
Other		0	0
Contingent capital gains tax liability:			
Real estate			0
TOTAL LONG TERM LIABILITIES		237,500	237,500
TOTAL LIABILITIES		272,125	272,125
NET WORTH		103,337-	3,337-
TOTAL LIABILITIES AND NET WORTH		168,788	268,788

10-1-88

S. K. Watkins
Testimony before Subcommittee
on Energy and Agricultural Taxation

EXHIBIT 4

CAPITAL GAIN	TAX RATE	TAX
$59,500.00	28%	$16,660.00
150% OF $16,660.00 = $24,990.00		
$350,000.00	28%	$98,000.00
150% OF 98,000.00 = $147,000.00		

Examples of tax due do not take into consideration Alternative Minimum Tax or any other factors that could influence tax due.

COMMUNICATIONS

ANDREWS, DAVIS, LEGG, BIXLER, MILSTEN & PRICE,
Oklahoma City, August 9, 1989.

LAURA WILCOX,
Hearing Administrator,
Senate Finance Committee,
Washington, DC.

Re: Comments on S. 1041

Dear Ms. Wilcox: These comments are submitted for the record and hearing on Senate Bill 1041 dealing with tax relief for certain farmers on the transfer of farm property in satisfaction of farm indebtedness.

I believe that substantially greater relief in this area is needed than the relief provided by this bill. Specifically, the bill should expand the exclusion of discharge income for bankrupt and insolvent taxpayers under Section 108(a)(1) to include "gain" on the transfer of property to a creditor.

It is only now becoming apparent that a tremendous problem to insolvent debtors was created by an amendment to regulations made in 1980, shortly after Congress completed its consideration of the Bankruptcy Tax Act of 1980. Without statutory justification and contrary to congressional understanding of law at that time, this change attempted to limit the exclusion of income on transfer of property by insolvent taxpayers. *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d 95 (5th Cir. 1934) held that no income was to be recognized on the transfer of property to a creditor by a taxpayer who remained insolvent after the transfer. This decision included both "discharge income" and what is now characterized under the Section 1001 regulations as "gain." This decision was cited with approval in the Committee Reports for the Bankruptcy Tax Act of 1980. It was followed by the IRS in private letter rulings during 1980. See PLR 8019018.

Then, near the end of 1980, changes to the regulations under Section 1001 were adopted without opportunity for public comment. The change provides that the exclusion from income from insolvent taxpayers does not apply to the portion of income on transfer of property which regulations characterized as "gain" as opposed to discharge."

The Internal Revenue Service has just recently announced a further interpretation regarding the application of these regulations in bankruptcy proceedings. See PLR 8918016, PLR 8928012 and Letter dated 3-14-89 from James J. Keightly, Associate Chief Counsel (Litigation) to Richard L. Paup, Deputy Assistant Attorney General, Tax Division, available through Tax Notes Today, June 16, 1987, as Doc 89-4829 or 89 TNT 125-9. This new position is that where property is abandoned by a bankruptcy trustee in order to allow the creditor to complete foreclosure, the "gain" on the foreclosure sale will be taxed to the individual debtor as personal post-petition income. The result of this interpretation is to circumvent the "clean start" concept of the bankruptcy law and burden the individual taxpayer with a nondischargeable tax liability, even where the bankruptcy estate may have had losses that might have offset the taxable gain or might have had unencumbered assets that could have been used to pay the tax.

S. 1041, as I understand it, would give some relief against taxation of "gain" on transfers to creditors. However, the relief that is needed is not limited to farmers and is not limited to any specified dollar amount. The relief that is needed is to overturn the 1980 regulations under Section 1001 and restore the holding in *Dallas Transfer*.

I would doubt that this further change would have any significant revenue effect as I doubt if much, if any, of the tax the IRS may assert in this area is ever collectible. However, the IRS position discourages many insolvent individuals from reorganizing their affairs through bankruptcy or otherwise because there is no way out."

Sincerely,

TIMOTHY M. LARASON.

HEIDEPRIEM, WIDMAYER & ZELL,
Miller, SD, August 7, 1989.

LAURA WILCOX,
Hearing Administrator,
Senate Finance Committee,
Washington, DC.

Madam: This letter is written in support of S. 1041 relating to tax treatment of Farmers' Debt Cancellation on which the Senate Finance Subcommittee on Energy and Agricultural Taxation is holding hearings.

The reason why we are in favor of passage of this bill is that we are in a rural, agricultural, depressed area. Many of the farmers/ranchers in our area through debt restructuring have survived only through debt forgiveness.

As a result of this debt forgiveness, the situation has improved and enables them to continue with the operation of their farms and ranches.

However, to impose the additional hardship of a tax on the debt forgiveness will only put them back in their original position. These farmers and ranchers simply do not have the sources and funds to pay such a tax if levied.

We, therefore, favor the passage of S. 1041 and appreciate anything which you might be able to do to assist in passage.

Thank you for your assistance.

Yours very truly,

RUBEN R. WIDMAYER.

STATEMENT OF NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

By press release dated July 20, 1989, Senator David L. Boren, Chairman of the Subcommittee on Energy and Agricultural Taxation of the Committee on Finance, invited interested parties to submit comments on the tax consequences of certain restructured farm debts. The National Society of Public Accountants ("NSPA" or "National Society") is pleased to submit the following comments in response to the Chairman's request.

The membership of the National Society of Public Accountants consists of over 23,000 individuals, most of whom are sole practitioners or partners in small-sized public accounting firms. NSPA members provide accounting, auditing, tax preparation, tax planning, financial planning, and managerial advisory services to approximately 6 million individual and small business clients. With a nationwide constituency, a significant percentage of NSPA members provide these services to agricultural clients. Thus, the National Society is both familiar with and affected by the instant subject.

The tax consequences of farm debt restructuring arise as a result of two key provisions of the Agricultural Credit Act of 1987. That law gives the Farmers Home Administration (FmHA) the authority to restructure farm debt by creating an arrangement in which, in exchange for more affordable monthly payments, the farmer enters into either a "shared appreciation" or a "recapture" agreement with the Agency.

Technically, these restructuring options result in the discharge of indebtedness; such amounts are therefore includable in gross income under Section 61(a)(12) of the Internal Revenue Code. However, two inequities follow from this result: the farmer has actually paid a potentially heavy price for the discharge of indebtedness, and, the tax results thwart the farm policy objectives.

Before examining these two difficulties in detail, it should be acknowledged that Section 108 of the Code does provide some relief from the harsh dictates of 61(a)(12). If any of four enumerated exceptions are met, restructuring under the Act will not result in discharge of indebtedness income; in all other instances, the discharged amounts are includable in gross income.

As indicated above, several inequities flow from this scheme.

Although the tax policy behind the general inclusion of discharged debts in a taxpayer's gross income is long-settled, the equities in doing so for farm debt restructuring are not readily apparent. The farmer has paid a potentially hefty, albeit not readily definable, premium for the write-down; future equity may have to be shared with, or, in the case of recapture agreements, outright turned over to, the government. While the agricultural policy considerations behind such a requirement are understandable, the tax consequences act as a patently unfair "double whammy" against a taxpayer whose financial resources are already stretched perilously thin.

This highlights the second inequity in the status quo. In order for a farmer to seek debt restructuring, he or she Is likely fairly close to insolvency. The whole purpose of the Agricultural Credit Act is to avoid forcing the farmer into that unfortunate situation. At the same time, the farmer is certainly in no better a position to satisfy a tax liability on forgiven debts than he or she was in to satisfy the underlying debt itself. Thus, the tax law may well push the farmer into precisely the bankruptcy the Agricultural Credit Act seeks to avoid.

Another common problem affecting the agricultural clients of NSPA members relates to the gain realized upon the transfer of a capital asset to a lending institution in satisfaction of a farm indebtedness. Here the situation under present law is even worse. Not only is the farmer in this transaction required to report income on the cancellation of indebtedness, since the tax law treats the transfer as a sale, he or she is also required to recognize any resulting gain. This final Insult, when added to the earlier injuries, is generally fatal to the success of any restructuring plan. The farmer is left with the impression that the government has taken away with one hand that which it has given with the other.

Such a result, however unintentional, is clearly undesirable. While one can debate *ad infinitum* the merits of the nation's farm policy, there is no benefit to be gained by having one body of Federal law (i.e., the Internal Revenue Code) in direct conflict with the objectives of another body of that law (i.e., the Agricultural Credit Act). Neither law is in and of itself flawed, but, taken in tandem, they produce a potentially calamitous result.

Nor should one point an accusing finger at the Internal Revenue Service in this instance. The tax code is clear on this point, and the agency would be derelict in its duty were it to decline enforcement of the law.

While undoubtedly a legislative oversight, the solution to this dilemma must nonetheless come from the Congress itself. Thus, the National Society would urge this Committee to act with haste and diligence in resolving this problem. As NSPA members who have attempted to assist their agricultural clients in rehabilitating their fiscal affairs can attest, every day of delayed action results in more farmers losing their farms because the tax consequences of their proposed restructuring render their financial plans unworkable.

NSPA supports legislative efforts to assist financially burdened farmers by excluding written-down farm debt from gross income, as well as those efforts intended to avoid the taxation of any gain resulting from the transfer of farm assets to a lender. Accordingly, the National Society stands ready to assist the Congress In any way possible. Related enquiries should be directed to Peter M. Berkery, Jr., NSPA's Director of Congressional Relations-Tax Counsel.

NSPA applauds the Subcommittee on Energy and Agricultural Taxation for its leadership in addressing this important issue and is greatful for this opportunity to present its views.

STATEMENT OF JAMES I. SHEPARD, J.D., LL.M.,[1] BANKRUPTCY/INSOLVENCY TAX CONSULTANT, FRESNO, CA

I. Background

Senate Bill 1041,[2] introduced May 18, 1989, addresses two concerns. The Bill would create an exception from taxation for capital gains realized from transfers of farm property in complete or partial satisfaction of certain farm debt and modify the formula under which solvent farmers experiencing a discharge of qualified debt determine their tax consequences. The Bill currently under consideration is similar to Senate Bill 2873[3] introduced at the close of the 100th Congress. Senate Bill 2873 addressed the two concerns mentioned above, and in addition, proposed that an abandonment of property by a trustee in bankruptcy pursuant to section 554 of the Bankruptcy Code be a taxable event and that the separate entity rules of section 1398 of the Internal Revenue Code[4] be imposed on Chapter 12 bankruptcy estates. On reintroduction in the 101st Congress Senate Bill 1041 omitted the proposed changes in the taxation of bankruptcy. Testimony presented to the Subcommittee with regard to the hearing held July 28, 1989, on the Tax Treatment of Certain Farm Indebtedness, urges the adoption of legislation reincorporating the bankruptcy tax provisions previously deleted. This paper addresses the propriety of the proposed additions to the Bill pertaining to the taxation of bankruptcy.

II. The Tax Treatment of Abandonment of Property by a Trustee

A. THE TECHNICAL RULES

1. The basics of gain and loss

As a general statement of tax law, unless specifically provided otherwise, all transfers of property, by sale, exchange or other disposition, are taxable, causing either gain or loss to be realized. The excess of amount realized on the sale or other disposition of property over its adjusted basis is the measure of the amount of gain realized, while the excess of adjusted basis over amount realized determines the amount of loss realized.[3] Generally, the amount of money and fair market value of any property received on the sale of property is the amount realized.[6] Adjusted basis used in determining gain or loss generally begins with the cost of the property [7] and is adjusted for additions due to improvements and reductions because of wear and tear, depreciation, and obsolescence.[8] With property acquired by bequest, devise or inheritance, the basis to be adjusted is its fair market value on the date of decedents death.[9] Property acquired by gift has a basis for purposes of measuring gain of the donor's adjusted basis and a basis for purposes of measuring loss of the lower of fair market value or the donor's adjusted basis.[10]

2. The cancellation of debt and debt discharge income

United States v. *Kirby Lumber Co.*,[11] an early United States Supreme Court decision, established the doctrine that the satisfaction of an obligation at less than its face amount creates debt discharge income. This doctrine has been codified,[12] and it is now generally recognized that the discharge of indebtedness causes income. Exceptions to this doctrine are found in section 108 of the Internal Revenue Code, the exclusionary rules. These rules provide, generally, that when the discharge occurs in bankruptcy,[13] while the taxpayer is insolvent,[14] or if the discharge is of "Qualified Farm Debt" of a solvent farmer,[15] the amount of debt so discharged or cancelled will not be included in gross income.

3. The transfer of property in satisfaction of debt

When property is transferred in partial payment of debt and the creditor cancels part or all of the deficiency remaining, not only do the exclusionary rules apply, other rules apply as well. Judicial decisions uniformly treat the transfer of property in satisfaction of debt as a sale of such property, causing the realization of gain or loss, whether the transfer is voluntary,[16] as with a deed in lieu of foreclosure, or involuntary, as in the foreclosure or forfeiture of a contract, mortgage or deed of trust.[17]

a. The "One-Step" analysis

A series of court decisions culminating in *Commissioner* v. *Tufts*,[18] instructs that when property is transferred in satisfaction of nonrecourse debt, where the borrower has no personal liability for any deficiency, the full amount of the debt satisfied will be used in determining the amount realized. Known as the "One-Step" analysis because of its ignoring the question of the fair market value of the property transferred, this approach to the determination of gain or loss is applicable in all cases of transfers in satisfaction of nonrecourse debt.

b. The "Two-Step" analysis

In contrast with the *Tufts* approach applicable to transfers of property encumbered by nonrecourse debt, Treasury Regulations hold that the "Two-Step" analysis is to be used in determining gain or loss on transfers of property in satisfaction of recourse debt.[19] Recourse debt is characterized by the borrower's potential personal liability on any deficiency which may remain after a foreclosure. This approach treats such transfers as a sale of the subject property at its fair market value with the application of the proceeds of the deemed sale in payment of the debt. The excess of debt over fair market value is debt discharge income; the amount realized on the deemed sale does not include any amount that is income from discharge of indebtedness or which would be if not excluded because of the exclusionary rules.[20] If the discharge of recourse debt is accomplished by the transfer of property in kind, such as the deed to a mortgage holder in lieu of foreclosure, the amount to be excluded is the excess of the debt satisfied over the fair market value of the property.[21] The amount realized on such transfers is the fair market value of the property if the debt satisfied is recourse and the full amount of the debt satisfied if nonrecourse.[22] If payment of the debt would have been deductible, the payment of a livestock feed bill by a farmer or rancher, for instance, cancellation does not cause income from discharge of indebtedness.[23] Although such debts may enter into the calculation of gain or loss realized, when a deductible expense is paid with property, any gain recognized will be offset by the deduction created.

B. THE DEBTOR'S TAX PROBLEM

1. Common Illustrations

Written testimony submitted to the Subcommittee in support of statements made at the hearing on July 28, 1989 [24] illustrated the tax problem in question with the example of a farmer filing bankruptcy owning a bin of shelled corn in which a local bank has a security interest. Because the bank's lien exceeds the value of the corn the trustee in bankruptcy abandons the grain. As a raised crop, the corn has a "zero" basis for tax purposes; whatever is realized on a creditor's foreclosure sale is fully taxable.

Another example, frequently used to illustrate the potential problem of abandonment of property by a trustee in bankruptcy, is the farmer who files bankruptcy owning farm land with substantial value in excess of the mortgage debt but with a low basis. The foreclosure of a mortgage, for instance, against farm land with an adjusted basis of $1,000 per acre, a fair market value of $1,750 per acre, and subject to recourse debt of $2,000 per acre, will produce gain of $750 per acre, the difference between fair market value and basis. Further, unless the exclusionary rules apply, debt discharge income of $250 per acre will be realized, the excess of debt over fair market value.

2. The Property Abandoned

While examples such as these are frequently used to illustrate the problem perceived, trustees abandon many other and different kinds of property. To give perspective to the circumstances producing the problem complained of, additional examples must be considered. A review of the wide variety of types of property abandoned illustrates that the proposed change in the taxation of abandonments affects not only farmers, but debtors in nearly any occupation or business. In the experience of the author in supervising the preparation of bankruptcy estate income tax returns, abandoned property includes: farm machinery in which the debtor has equity in excess of the allowed exemption amount, but not enough to satisfy the creditor's lien, the debtor's exemption, costs of sale and taxes incurred on the sale; accounts receivable which the trustee deemed cost effectively uncollectible; the debtor's retirement fund where the cost of litigating the propriety of the debtor's claim of exemption was deemed excessive; the debtor's residence where the equity in excess of the creditor's security interest and the debtor's claim of exemption was deemed insufficient to pay the costs of sale and the taxes incurred on the sale; [25] claims against third parties for tort, breach of contract or any one or more of a myriad of civil actions where the trustee may determine that the potential for recovery and the costs of suit do not merit pursuing the matter on behalf of the estate; and the debtor's interest in a partnership from which the debtor has taken distributions in excess of his capital contribution and in which he has a zero basis for tax purposes. These and a great deal more items of property or interests in property have been abandoned by trustees, not just farm property. All such property, however, would be treated the same under the proponents suggestions: the estate would pay the tax on any taxable gain and the debtor would get a step-up in basis.

The problem complained of arises not because of the abandonment per se, but because of what frequently follows, the creditor's mortgage foreclosure action. As discussed above,[26] the completion of the foreclosure against property is a taxable sale of such property. Proponents argue that all abandonments of property pursuant to sections 554(a) or (b) of the Bankruptcy Code should be taxable to the estate. As will be shown, such abandonments are not and should not be taxable events.

C. THE INTERNAL REVENUE CODE AND BANKRUPTCY CODE APPLIED

As expected, in order to understand the taxation of abandonments in bankruptcy, it is necessary to refer to both the Internal Revenue Code and Bankruptcy Code. The Internal Revenue Code, the beginning point of a study of the subject, provides that on commencement of the case the transfer of property to the bankruptcy estate from the debtor is not a taxable disposition for any purpose.[27] Similarly, on termination of the estate, the transfer of any property from the estate to the debtor is not a taxable event for purposes of any tax consequences.[28]

The Bankruptcy Code provides that a trustee may abandon property, after notice and hearing, if the property is burdensome or of inconsequential value and benefit to the estate.[29] On the request of a party in interest, the court may order the trustee to abandon property.[30] Any property remaining when the estate is closed and which has not otherwise been administered is automatically abandoned to the debtor.[31] Because the trustee's purpose is to liquidate the estate for the benefit of the unsecured creditors, he need not take property burdensome to the estate; the unsecured creditors would not receive any benefit.[32] Where administration of the property does not benefit the estate, i.e., the creditors, abandonments are within the discretion of the trustee.[33]

D. TWO THEORIES OF THE TAXATION OF ABANDONMENTS

Two theories of law have developed which hold that the trustee's abandonment of property pursuant to section 554 of the Bankruptcy Code is not a taxable event.

1. *The Cruseturner doctrine*

The first theory relies on the treatment bankruptcy courts have given to the abandonment of property for bankruptcy purposes. This theory which has its roots in the judicial opinions in two bankruptcy cases, is founded on the proposition that such transactions should be taxed according to their character under bankruptcy law. *Mason* v. *Comm'r,*[34] a Ninth Circuit Court of Appeals decision, examined the effect of bankruptcy on a corporation's Subchapter "S"[35] status when a shareholder filed bankruptcy and the trustee abandoned the shares of stock. The Court found, based on pre-Code bankruptcy law, that the corporation's Subchapter "S" status was not affected by the shareholder's bankruptcy; on abandonment the stock was treated as if it had never been property of the estate. Subsequently, the landmark bankruptcy court decision of *In re Cruseturner,*[36] examined the effect of the abandonment of property during the administration of the estate, from the aspect of the rights of the parties to the property. After an extensive analysis, the Cruseturner Court came to the same conclusion; upon abandonment of property the debtor regains his or her former interest as if such property had never been property of the estate.[37] Other courts have examined similar issues from the stand point of the rights of the parties in abandoned property and have uniformly come to the same conclusion.[38]

The cases cited above are clear. For purposes of the rights and interests of the debtor, the creditors, and any other interested party, property abandoned by a trustee is treated as if it had never been property of the estate. Whatever pre-bankruptcy rights and interests existed are restored on abandonment.

Because bankruptcy treats such property as if it had never been property of the estate, so should tax. If abandoned property was never property of the bankruptcy estate, the estate can not have transferred the property in a taxable disposition. If a creditor forecloses its mortgage or security interest in such property after abandonment, creating a deemed taxable sale, the tax consequences are not those of the estate, the property sold was never property of the estate. In the same manner, should the debtor retain the property after its abandonment he is also entitled to retain the rents or other post-abandonment income from such property.[39]

Only when property is sold or otherwise disposed of in a taxable transaction while property of the estate, will the estate be taxed on the gain. *In re Bentley,*[40] a recent United States District Court decision, addressed the issues raised by the attempted abandonment of proceeds from the sale of property of the estate. The *Bentley* trustee sold zero basis, stored corn and held the proceeds in an interest bearing account. Three years later funds sufficient to satisfy the Commodity Credit Corporation's lien were "abandoned" directly to that creditor. On the debtor's objection to the trustee's application to abandon, the Bankruptcy Court held, in essence, that it was an effective, non-taxable abandonment.[41] On appeal the District Court ruled that the sale of property and subsequent abandonment of the proceeds to the secured creditor does not retroactively shift the tax burden to the debtor; the estate incurred the tax liability on the income realized.[42] The District Court recognized that any attempt by a taxpayer to divest himself of the tax consequences of a sale occurring in a prior taxable year would violate the rule of accounting periods" and the computation of taxes on the basis of a taxable year. The Court, however, did not specifically address the question of the tax consequences of an abandonment of property, as opposed to the proceeds from its sale.

2. *Internal Revenue Code Section 1398(f)(2)*

The second legal theory under which a trustee's abandonment of property is held to be tax free rests upon Federal income tax law, the provisions of the Bankruptcy

Tax Act,[44] found in section 1398 of the Internal Revenue Code. *In re McGowan*, a recent bankruptcy court decision, held that upon abandonment of property by a trustee pursuant to section 554(a) of the Bankruptcy Code, the property reverts to the debtor together with all rights attached; any gain realized from a subsequent foreclosure is taxable to the debtor and not the bankruptcy estate.[45] The Court chose not to base its opinion upon the bankruptcy law theory of abandonment enunciated in *Cruseturner* and its progeny. Instead, the Court relied on I.R.C. section 1398(f) (2) which, as indicated above, provides that a transfer from the estate to the debtor on termination of the estate is not a taxable disposition. The Court concluded that "'termination of the estate' for purposes of I.R.C. § 1398(f)(2) included the termination of the estate's interest in property under 11 U.S.C. § 554(a)." [46]

In a more recent decision, *In re Olson*, the *McGowan* Court re-examined its position and indicated that its earlier decision may have been "overbroad in defining property abandonment during administration as 'termination of the estate' under 26 U.S.C. § 1398(f)(2).' '[47] The Court concluded, however, that property abandoned during administration of the estate should be treated the same as property "abandoned by operation of law as a result of its being unadministered at the close of a case." [48] The Court recognized that the application of the Cruseturner doctrine would produce the same effect, but that it was not necessary to rely on that theory "to determine that there is no tax liability to the estate from abandonment of estate property."[49] The position of the *McGowan* and *Olson* Court is well taken. Because abandonments at the close of a case under section 554(c) of the Bankruptcy Code are not taxable, as provided by I.R.C. section 1398(f)(2), abandonments during the administration of the estate under sections 554(a) or 554(b) of the Bankruptcy Code should be similarly treated.[50]

E. THE POSITION OF THE IRS

The Internal Revenue Service [51] recently announced its position with regard to the proper treatment of the abandonment of property by a trustee in bankruptcy for tax purposes. In a response to a request for guidance the I.R.S. advised the Tax Division of the U.S. Department of Justice that the abandonment of property by a trustee in bankruptcy is not a taxable event, citing *McGowan* with approval.[52]

> We agree with the *McGowan* court to the extent that it supports the view that congress did not intend to tax the estate upon abandonment of property under 11 U.S.C. § 554. We believe I.R.C. § 1398(f)(2), coupled with the bankruptcy policy of obtaining maximum distribution for general creditors, can be used as additional support for the conclusion that abandonment of property to the debtor is not a disposition of property that triggers tax liability.[53]

The contents of Keightly's letter [54] and the position of the Tax Division of the Justice Department were formally communicated to the United States Trustees at a meeting in March of 1989.[55] Further, prior to publicly announcing its position the Internal Revenue Service in a Private Letter Ruling, in response to a taxpayer's request for advice, discussed the implications of the exclusion of debt discharge income, the reduction of tax attributes and the calculation of gain on a post-abandonment foreclosure of real estate.[56] While not directly addressing the issue of the tax consequences of abandonments the letter ruling clearly indicates the view that they are not taxable dispositions.[57]

F. PROPONENTS' ARGUMENTS EXAMINED

Two commentators have taken the position that abandonments of property by a trustee pursuant to section 554 of the Bankruptcy Code either are or should be treated as taxable events.[58] Because these authors strenuously urge the adoption of legislation that would, among other things, cause abandonments to be a taxable event to the estate, a close study of their arguments is merited.

1. The debtor's fresh start

It must be noted at the outset, that the foundation upon which the proponents arguments for causing abandonments to be taxed to the bankruptcy estate is the sometimes misplaced compassion for the debtor.[59] The proponents exalt the debtor's fresh start. The fresh start, it must be remembered, exists in concept only—it has not been codified. The only authoritative congressional reference to the debtor's "fresh start" the author has found are two statements in legislative history: the first in reference to the property which the debtor may claim as exempt under section 522(d) of the Bankruptcy Code,[60] and the second in reference to the Chapter 7 discharge itself under section 727(a) of the Bankruptcy Code.[61]

The Bankruptcy Code in comparison with the former Bankruptcy Act,[62] does provide a very liberal list of property which the debtor may claim exempt.[63] However, in spite of this liberalization of exemptions under Federal bankruptcy law, the states were allowed to "opt out" and impose their own exemptions upon resident debtors, even though substantially more conservative.[64] Further, while liberalizing the debtor's exemptions, Congress retained in the Bankruptcy Code specific terms which provide that certain of the debtor's taxes, generally those incurred within the three year period preceding bankruptcy, are not dischargeable.[65] These provisions similar to those found in section 17 of the former Bankruptcy Act were modified only by the reduction in the time period in which the IRS can collect taxes.[66] In addition, judicial decisions have long sustained the fact of certain of the debtor's taxes being nondischargeable.[67] The debtor's "fresh start," therefore, can only be understood to be tempered by the requirement that certain taxes will not be discharged.[68]

2. Abandonments under the Internal Revenue Code

The proponents argue that the Bankruptcy Tax Act failed to address the tax consequences of abandonment of property during the administration of the estate.[69] While section 1398 of the Internal Revenue Code does not specifically address abandonments under sections 554(a) or 554(b) of the Bankruptcy Code, section 1398(f)(2) does contemplate the abandonment of property which is not administered. That Code section refers to the transfer of property back to the debtor on "termination" of the estate.[70] As recognized by the *McGowan* court, the technical difference in the similar provisions within the sub-sections of section 554 are not sufficient to require a different result. When property is returned to the debtor "with all rights attached" the concept of I.R.C. section 1398(f)(2) should apply. This conclusion is valid whether the abandonment is the result of the Chapter 11 debtor's plan of reorganization, the Chapter 7 debtor's pre-bankruptcy planning, or the Chapter 7 trustee's abandonment of property over the debtor's objection.

Guidance explaining the purpose of section 1398(f)(2) is not available. It is readily apparent, however, that in the context of the Chapter 11 case, because the debtor will retain the property for use in business post-confirmation, a taxable disposition in the any sense of the term has not occurred. Similarly, when the debtor has the right to retain property after the trustee's abandonment in a Chapter 7 case, a taxable disposition has not occurred.

3. THE ESTATE'S OBLIGATION TO SATISFY DEBT

The proponents argue that the abandonment pursuant to sections 554(a) or (b) should be deemed a taxable event because the estate has realized a benefit.[71] It is asserted that the estate is obligated to satisfy the underlying debt secured by the mortgage upon the property and, therefore, when the trustee abandons the property this relieves the estate of its obligation. It is argued that the principles of *Crane* [72] and *Tufts* [73] apply. Those cases held that on the sale of property subject to non-recourse debt the amount realized included the debt satisfied. An abandonment in bankruptcy is a taxable event, it is argued, because, by abandoning property subject to debt, the estate realizes a benefit in the form of relief from the obligation to satisfy the mortgage. The argument is made that this relief is sufficient consideration to constitute a sale of the property.[74] These arguments fail for two reasons.

First, the fundamental premise that the abandonment of the property satisfies the indebtedness owed is not true; abandonment of the property does not affect the creditor's claim in any manner. The proponents focus on the sale of the abandoned property to a third party, the mortgage holder or the purchaser at foreclosure sale, as proof of the trustee's obligation to satisfy the underlying mortgage.[75] There is no satisfaction or relief of debt, however, as a result of the mere abandonment; the assets of the estate remain subject to the creditor's claim. The Bankruptcy Code recognizes the creditor's continuing claim against the estate in its treatment of a claim as both secured and, to the extent of any deficiency, unsecured.[76]

The argument is made that the estate is obligated to satisfy the mortgage, to continue to make payments on the mortgage. This reasoning is erroneous. The estate does not automatically "step into the debtor's shoes" with regard to the financial obligations associated with property. While a creditor may have a claim against the assets of the estate for prepetition amounts due, the estate's obligation does not include any debt which arises postpetition.[77] Further, if the Chapter 11 debtor wants to retain property subject to a secured creditor's claim, for instance, the plan of reorganization must provide only for payment of the property's fair market value.[78] Because the trustee's primary duty is to liquidate the debtor's property for the satisfaction of prepetition claims for the benefit of the unsecured creditors,[79] the Bankruptcy Code gives trustees considerable latitude in dealing with property of the estate. Subject to court approval, the trustee has the power to sell such property.[80] Further, the trustee may remove the property from the estate by means of abandonment, neither satisfying the mortgage nor determining the rights of any parties to the property.

Second, the transfers of property in *Crane* and *Tufts* were "sales;" the parties entered into agreements under which the purchaser contractually agreed to take the property subject to the debt. In *Milledge L. Middleton* [81] and *Yarbro* v. *Comm'r,*[82] frequently cited in support of taxable abandonments, this contractual agreement can be found in the mortgage documents where one of the secured creditor's remedies in the event of a default was the right to foreclose against the property. When the trustee abandons property, in contrast, there is no agreement to transfer the property. The act of abandonment of property pursuant to section 554 of the Bankruptcy Code is a unilateral act of the trustee, for which consideration is neither exchanged nor required.

Further, by focusing on the transfer of the property as a sale under the *Crane-Tufts* theory, Nelson has isolated the abandonment from the complete transaction. If there is a true taxable abandonment of property in satisfaction of debt, the abandonment began immediately prior to bankruptcy when the debtor decided to "walk away from the property" and file bankruptcy; before the property became "property of the estate." [83] At that point, because there was no equity which could be applied in payment of unsecured debts it can only be assumed that the debtor intended to transfer the property to the secured creditor in full satisfaction of such debt. The opinion in *Matter of Rasmussen* [84] recognized this "conduit" approach to the analysis of the tax consequences of abandonments. Logically if property is sold or otherwise disposed of by a trustee in bankruptcy, other than by abandonment, the taxable event should be deemed to occur in the estate. Because the estate receives the cash from sales of property and has the use of the debtor's other tax attributes the estate should bear the tax burden. The abandonment of property, however, is not such a sale; if a creditor later forecloses and the property is sold, abandonment was but one step in the debtor's transfer of the property in payment of the secured debt.

Nelson argues that there is nothing "magical" about the abandonment of property in bankruptcy; that there is "no inherent reason why the transfer should be treated any differently just because it occurs during bankruptcy." [85] The abandonment of property in bankruptcy is unique, no directly comparable concept exists elsewhere in property law.[86] As discussed below, abandonment does not in any way affect the claims or rights and interests of other parties in the property. *Crane* and *Tufts,* like *Middleton* and *Yarbro,* it must be remembered, were not bankruptcy cases. In contrast with the sales or deemed sales of property in those cases, the property abandoned in bankruptcy remains subject to all prepetition claims. The sale of property, by contrast, whether by voluntary contract or as a result of foreclosure, alters the rights of all the parties in the property.

The difference between the taxable dispositions of property under *Tufts* and Treasury Regulations section 1.1001-2, and the trustee's abandonment is that the trustee's act does not automatically lead to a final disposition of the property in which the debtor's title is transferred in exchange for the satisfaction of debt. The rights of the debtor intervene between the trustee's abandonment and the creditor's foreclosure. If the debtor chooses to renegotiate or reaffirm the debt he may do so; the debtor will therefore retain the property. Similarly, the debtor has the right to contest the creditor's foreclosure action, to assert that the security interest is invalid, for instance, a claim the trustee possibly should have pursued. If successful the debtor will keep the property. Further, the secured creditor is not obligated in all cases to exercise its right of foreclosure. When the costs and benefits of foreclosure are not justified, the secured creditor may forēgo foreclosure and file a claim as an unsecured creditor for the full amount of the debt owed.[87]

4. The lack of foreclosure—no sale

The proponents' argument presumes that all property will be foreclosed upon after it is abandoned by the trustee. While post-abandonment foreclosure frequently occurs, in the author's experience the two are not inexorably joined together. Although such property may ultimately be foreclosed upon, debtors may be able to retain and/or benefit from the abandoned property, as evidenced, for instance, by the fact pattern discussed in Private Letter Ruling No. 8918016.[88] Debtor's may be able to reaffirm [89] and continue paying the secured debt, and thus be able to keep the property. The reaffirmation and continued payment of debt may occur where the debtor has claimed an exemption in the property and the equity in excess of such exempt amount is insufficient to satisfy both the claim of exemption and the expense of sale including the taxes incurred. Abandonment of such property is almost always assured because of the lack of any realizable benefit for the estate. The debtor will regain his interest in the property and may be able to negotiate favorable terms for payment of debt. The debtor will have the use and benefit of the abandoned property.[90]

In support of this argument *Middleton* [91] and *Yarbro* [92] are frequently cited. Those cases addressed the question of the proper tax treatment of the non-bankruptcy abandonment of property by a *taxpayer* to a *creditor*. The taxpayers in both those cases "walked away" from property subject to secured debt and attempted to claim an ordinary "abandonment loss" under I.R.C. section 165. The courts in both cases held that the taxpayers' actions caused a taxable sale; there had been a transfer of property to the creditor effectively paying the obligation owed. The losses incurred, therefore, were capital losses subject to the limitation of deductibility under I.R.C. section 1212(b) and not ordinary losses.

The abandonment of property by a taxpayer to the secured creditor is, of course, not the same as the abandonment of property by a trustee to the debtor. In bankruptcy the lack of a deemed sale of property in satisfaction or cancellation of debt as a direct result of the abandonment demonstrates that a taxable disposition has not occurred. Because the debtor is restored to his rights and may retain the property, debt has not been satisfied merely because the property was abandoned. As discussed above, the creditor may elect to forego foreclosure and file a claim for the full amount of the debt owed.

A taxable sale of property occurs on the transfer of value, an intentional shifting of an Interest in property, in exchange for value. Absent the exchange of value no consideration is given. The satisfaction of debt, the consideration required to make an abandonment of property a taxable disposition, does not occur until the foreclosure sale after the abandonment of the property.[93] The proponents' arguments fail because of the absence of consideration; a foreclosure may never be completed and no debt satisfied as a result of the mere abandonment—there is no consideration exchanged for purposes of a sale.[94]

5. The Cruseturner doctrine—applied for tax purposes

In his article, Nelson criticizes the result in *Cruseturner*.[95] He does not, however, suggest that it is an incorrect interpretation and application of bankruptcy law. He merely states that application of the *Cruseturner* doctrine "disregards the true nature of the transactions and treats them as if they never occurred." [96] This assertion is founded on the view that debt is satisfied by the mere act of abandonment, an argument rebutted above.

As Nelson admits, *Cruseturner* was not a tax case. The issue presented to the court was the proper characterization of property after abandonment for bankruptcy purposes. The decision resolved the issue. For tax purposes then, the issue is how to apply the Federal income tax laws when property has been abandoned by a trustee, in light of the rules of law presented in section 554 of the Bankruptcy Code and *Mason* and *Cruseturner?* The examination of the post-confirmation foreclosure of property in a Chapter 11 case is instructive. As previously noted,[97] on confirmation of the Chapter 11 plan, except as otherwise provided in the plan or in the order confirming the plan, all property of the estate vests in the debtor and the estate terminates for tax purposes.[98] The tax free transfer of the property in that instance is clearly provided under I.R.C. section 1398(f)(2). Should a creditor foreclose upon any such property at that point there is no question but what the debtor will incur the tax liability. In the Chapter 7 setting where the debtor may retain the property after the trustee's abandonment, Cruseturner reaches the same result. *Cruseturner* places Chapter 7 and 11 debtors on a parity.[99] To say that *Cruseturner* is wrong because it produces a tax result which may be adverse to the debtor, does not in any way refute the validity of the decision or its applicability in determining the tax consequences of abandonments. As discussed above, because bankruptcy treats abandoned property as if it had never been property of the estate, so should tax.

6. Direct abandonments to a creditor

Nelson also suggests that the legislative history indicating that property may be abandoned to anybody with a "possessory interest" refutes the *Cruseturner* doctrine that abandoned property should be treated "as if no bankruptcy had been filed." [100] The argument ignores the fact that the debtor is logically the one most often entitled to possession of the property.[101]

Further, a creditor who held a prepetition possessory lien under state law, the auto mechanic holding the debtor's motor vehicle to assure payment of a repair bill, for instance, should be returned to possession of the vehicle on abandonment. Possessory liens often exist under state law where stocks, bonds and other securities are used as collateral for loans.[102] The bank or other creditor holding a lien on corporate bonds or other marketable securities holds a "possessory interest" and should be returned to possession on the trustee's abandonment. The restoration of a creditor's possessory interest does not mean that the mechanic or the bank is legally entitled to the property, the bonds or the vehicle. Neither title nor the claims of third parties, such as prior creditors, have been determined. The property has not been liquidated or applied in payment of debt under state law, but was merely removed from the estate to relieve the unsecured creditors of any further expense.[103]

7. Two dissimilar taxpayers—disparate results

The proponents claim that treating an abandonment in bankruptcy as non-taxable will be inequitable because of a perceived disparity of tax consequences between two debtors whose positions are argued as the same.[104] The argument is without merit. Two seemingly similarly situated taxpayers often will have very different tax obligations because of differences in their tax attributes or their property. Because taxes are assessed on the basis of taxable periods, for instance, the same amount of taxable income will cause a different amount of tax when tax rates change. Two taxpayers, one who acquired land by purchase and the other by inheritance, who sell their property on the same day at the same price will have different tax consequences because of different adjusted bases. Similarly, two taxpayers acquiring property at the same cost and selling their property at the same time will have different tax consequences as a result of certain elections which may or may not have been made; the election to use straight line depreciation, for instance, as opposed to the accelerated Cost Recovery System.[105] In truth, the taxpayers described in proponents examples are not equal—substantial differences exist between their respective property holdings. The result complained of was not caused by the abandonment but by these inherent differences.

8. The taxable abandonment—a genuine inequity

A genuine inequity will exist, however, if the proponents suggestions are followed, because of the different tax consequences which will occur depending on whether or not the debtor files bankruptcy. debtor attempting a voluntary workout arrangement to resolve his financial problems outside of bankruptcy will encounter substantially different tax consequences in comparison with the proposed tax treatment given the identical transactions in bankruptcy. The debtor liquidating in bankruptcy will pay no tax on the disposition of such assets. The debtor liquidating the same assets outside of bankruptcy will not have the benefit of the tax free disposition.

F. TAXABLE ABANDONMENTS—ADVERSE RESULTS

If the proponents arguments are followed and the abandonment of property by a trustee in bankruptcy pursuant to section 554 of the Bankruptcy Code is treated as a taxable disposition, a number of very undesirable consequences will result.

1. *The Creditors Pay the Taxes.*—Because the taxes incurred during the administration of the estate are a first priority expense under section 507(a)(1) of the Bankruptcy Code, to the extent that there would have been funds available, the taxes owed will be paid ahead of the unsecured creditors who otherwise would have received a distribution from the estate. If the taxes incurred because of the abandonment of property exceed the available funds the unsecured creditors will receive nothing.

2. *Professionals Employed by the Estate Will be Forced to Share Their Fees.*—Because the taxes are a first priority administrative expense they will be paid on a par with the other administrative expenses of the estate—the trustee and the trustee's lawyer, accountant, appraiser or other professional people working for the estate.[106] In the Chapter 7 case if there are insufficient funds for the payment of these expenses they are to be shared pro rata.[107] Additionally, if interim payments have been made, such professionals may be surcharged to be able to distribute what funds are available pro rata.[108] It is conceivable that even the debtor's own lawyer may be forced to share his retainer with the tax authorities; the right to keep a retainer when the estate is insolvent is not clear.[109] The strong possibility of being required to share a fee will make it very difficult for the trustee to retain competent professional people to work for the estate. More importantly, this potential problem will make it difficult to find people willing to serve as trustees.

3. *The Debtor Gets a Step-Up in Basis.*—Because it is treated as a sale, the basis of property is stepped-up on abandonment, increased to at least its fair market value. Further, there is nothing in the proposed rules which requires that the property be transferred to a creditor. Because the abandonment would be treated as a taxable sale, the debtor would have acquired the property by a deemed purchase. The

debtor, therefore, will be able to retain the property and, if depreciable, take depreciation on the stepped-up basis. The property's fair market value on the date of abandonment would fix the amount realized and the debtor's new basis. If the property would appreciate after abandonment it is conceivable that the debtor could sell at little or no taxable gain,[110] while pocketing the appreciation in value.

4. *The Taxes Will Never be Paid.*—The taxes incurred by the estate which remain unpaid when the case is closed are treated the same as any other unpaid claim in the estate—they will never be paid. The Bankruptcy Code does not provide any means for the payment of unpaid administrative expenses in the event the estate becomes insolvent.[111] In the very likely event there is insufficient equity in the debtor's property to pay administrative expenses, the tax authorities will have only a limited opportunity to collect these taxes.

Absent transferee liability, the debtor will normally be discharged from liability for such taxes.[112] Even though the debtor may be allowed considerable exempt property, such property is not be subject to the government's claim for unpaid taxes. First, the property is "exempted from" the estate and not "transferred" to the debtor by the estate; [113] the debtor is therefore not subject to any transferee liability for the estate's unpaid taxes.[114] Second, and more importantly, exempt property cannot be charged with any of the administrative taxes incurred by the estate, even those incurred in a sale of property to obtain cash to satisfy the debtor's claim of exemption.[115] The net result is, in many cases, the government would be permanently deprived of the opportunity to collect part or all of what amounts to a deferred tax, a tax which should properly be considered nondischargeable similar to the "gap period" taxes mentioned above.[116]

5. *The Trustee Will Have to Hire but Cannot Pay a Tax Professional.*—If, as a result of the taxable abandonment of property, the estate recognizes income in excess of the minimum amount a tax return is required. This is true even though no cash is received and the estate is not able to pay its administrative expenses. The Internal Revenue Code makes no exceptions for taxpayers who realize income but receive no cash—an income tax return is required.[117] Returns will be due if the minimum income is reached even in the true "no asset" cases; those where all assets are either exempt or greatly over-encumbered and there is absolutely nothing for the benefit of the unsecured creditors.[118] In many cases a trustee will need to consult a tax practitioner just to learn if a return is required. If there are no funds available to pay administrative expenses how will the trustee pay the practitioner? Accountants and tax lawyers can not be expected to work for the estate without pay. Such professionals will be unwilling to work for the estate if there is a chance they will share their fee with the IRS.

It has been suggested that a trustee need not worry about the obligation to file returns on behalf of the estate in the situation described; that the trustee is not personally liable for the taxes in any event. There is, however, no exception from the obligation to file income tax returns merely because the estate's income is not received in cash. Bankruptcy estates with insufficient funds to pay administrative expenses, lien claims, debtor's exemptions, and the taxes incurred are still obligated to file returns and pay taxes.[119] Further, the authority frequently cited for the proposition that trustees do not have personal liability for the estate's income taxes, section 3713(b) of Title 31, United States Code,[120] relates only to the protection from liability for payment of Federal *claims* as required under the statute. This provision of law does not in any way exempt the trustee from the obligation to file income tax returns. The exception from personal liability provided by the statute only means that trustees will not be personally liable to the United States because of a violation of the priority statute when making a distribution of the estate's assets according to the manner of distribution required by the Bankruptcy Code.[121] Further, when a trustee fails to file income tax returns on behalf of the estate the IRS may file a claim against the trustee's bond for the unpaid taxes.[122]

6. *Interferes With the Administration of the Estate.*—Causing an abandonment pursuant to section 554 of the Bankruptcy Code to be a taxable event will interfere with the sound administration of the case. As mandated by *In re R.C. Machine & Tool Co.*, [123] the trustee's duty is to liquidate the estate as expeditiously as possible for the benefit of the *unsecured* creditors. If the trustee will incur a tax liability on the abandonment of property, an excessive amount of time and effort will necessarily be required to plan the affairs of the estate to manipulate the disposition of assets to minimize taxes. The trustee's goal will no longer be to maximize the value recovered on the liquidation of assets, but will become one of minimizing taxes for the sake of self preservation.

If the proponents suggestions are adopted only the debtor and the tax collector will benefit by the liquidation of the estate. The debtor will benefit because of the tax relief. The interests of the unsecured creditors in the expeditious liquidation will be subverted to the interests of the debtor in avoiding taxes. The tax collector will benefit, as a first priority claimant, to the extent of available funds [illegible]he taxes will be paid without any collection effort. This benefit, however, may be illusory. As previously discussed,[124] to the extent the assets of the estate are insufficient to pay the taxes they will go unpaid.

The debtor is presently in the position of controlling the distribution of the assets. To the extent the debtor holds assets with equity, the debtor can cause the proceeds from their liquidation to be used to pay the taxes incurred. Because taxes incurred within the three year period preceding bankruptcy have a 7th priority in the scheme of distribution,[125] the debtor is able to sell the property in question and pay the secured creditor or make a transfer directly to the secured creditor, either voluntarily or by suffering foreclosure, triggering the tax. Then, by electing to "terminate the taxable year" as provided by I.R.C. section 1398(d)(2), the taxes shown on the return filed for the first short period year ending the day before the petition in bankruptcy is filed will be a 7th priority claim in the estate. These taxes and any other prepetition taxes owed are payable out of the assets of the estate ahead of the unsecured creditors.[126] The debtor's dilemma, of course, is that if there are no or insufficient funds available to pay the taxes they will be nondischargeable.[127]

7. *Bankruptcy Will Become a Tax Haven.*—The tax advantages afforded under the proponents suggestions, the tax free liquidation of assets and the step-up in basis, will discourage voluntary cooperative workout arrangements and will encourage debtors to file bankruptcy where such voluntary arrangements were possible. Further, if adopted these proposals will cause bankruptcy to become a tax haven subject to the abuses of creative debtors and cooperative creditors. Debtors living in those states which do not limit the value of the homestead exemption or the value of retirement funds which may be claimed exempt, for instance, may find pre-bankruptcy planning particularly useful, as illustrated below.

No suggestion is made to limit the benefits of the proposed tax relief to individuals who may be truly deserving; those debtors who are without the ability to pay. High income taxpayers who would have been able to pay their taxes from current income or the liquidation of valuable exempt property, would be able to transfer property to secured creditors tax free by means of bankruptcy. Inasmuch as insolvency is not a requirement of the Bankruptcy Code for an individual becoming a debtor,[128] it would be possible for a debtor to convert all unencumbered assets into exempt property and file a petition in bankruptcy. The debtor would be able to keep the exempt property and, after abandonment, could transfer the over-encumbered secured property to the creditor. The debtor would have received a windfall, the tax free sale of property.

In the authors experience such professionals as doctors, dentists, and even a used car salesman were able to take bankruptcy because of tax shelter or other unwise investments and yet have annual incomes in excess of $100,000 within a short time. A Certified Public Accountant, for instance, who enters into an unsuccessful computer business while continuing his accounting practice could take bankruptcy to get rid of the computer related trade debt and still have substantial income. By reaffirming the debt, he would be able to retain real estate and other assets with values which historically appreciate at a high rate and sell the property at a greatly reduced tax because of the step-up in basis. In the alternative, even though he had the ability to pay such taxes, the C.P.A. would allow the over-encumbered, low basis property to be abandoned, knowing that the estate will stand the tax burden incurred on the foreclosure.

A midwestern farmer, as another example, could obtain a corn loan from the United States Department of Agriculture, Commodity Credit Corporation, by borrowing against harvested crops. The proceeds of the loan would then be used to reduce or pay off a mortgage against the homestead or other exempt property. Before the corn loan comes due the farmer would file bankruptcy knowing that after abandonment the corn would ultimately be transferred to the Commodity Credit Corporation in full satisfaction of the debt. The debtor has increased the equity in his exempt homestead; there are no assets in the estate with which the trustee can pay the taxes caused by the abandonment of the grain; the government cannot collect the balance of the unpaid taxes.[129] The result is, of course, the farmer has sold the corn tax free and has the benefit in the increased equity in the homestead.

Public policy should not make bankruptcy so attractive that it discourages payment of ones debts and encourages debtors to resort to what is considered an extraordinary form of relief.

III. THE CHAPTER 12 ESTATE AND THE SEPARATE ENTITY RULES

The proponents further assert that the rules creating separate taxable entities for individual Chapter 7 and 11 bankruptcy estates, section 1398 of the Internal Revenue Code, should be imposed on Chapter 12 estates.[130] In addition it is suggested that "Merely amending I.R.C. section 1398(a) to include Chapter 12 filers in the list of those eligible to utilize the Bankruptcy Tax Act of 1980 is all that would be required." [131] In a series of articles appearing in the *Norton Bankruptcy Law Adviser* the author has previously examined the merits of including Chapter 12 estates in the provisions of section 1398.[132] Not only should Chapter 12 estates not be included in the separate entity rules, but section 1231(b) of the Bankruptcy Code should be repealed.[133] The reasons are numerous.

It must be recognized at the outset, that the unstated motivation for wanting to include Chapter 12 estates in section 1398 is the perception that the debtor will be able to gain a tax advantage of some form. The mistaken tax advantage generally envisioned is the ability to transfer property from the Chapter 12 estate to creditors, either directly or by abandonment, thereby escaping the taxes which would be incurred on a sale or disposition of such assets outside of bankruptcy. Of necessity, for this mode of tax avoidance to work, of course, is the mandatory taxable abandonment of property, also sought by the proponents as discussed above. Two reasons are advanced for seeking the legislative inclusion of Chapter 12 estates in the separate entity rules.

First, it is implied that the separate entity is needed to avoid causing the recapture of investment credit on the transfer of assets to the trustee in bankruptcy.[134] The answer to this argument is very simple. Because the Chapter 12 bankruptcy estate is not a separate entity for tax purposes, the formation of the bankruptcy estate is of no tax consequence.[135]

Second, the proponents argue that the Chapter 12 estate should be a separate taxable entity to assure that the administrative expenses will be deductible. Again, the answer is simple: merely amend section 162 or 212 of the Internal Revenue Code to specifically provide for the deduction of the portion of the estate's administrative expenses related to the farm business. Alternatively, the same rule can be promulgated by Revenue Ruling or Treasury Regulation.

Were it all desirable, merely amending I.R.C. section 1398 to include Chapter 12 in the separate entity rules would be a gross mistake because of all of the procedural problems and questions created. The first and foremost obstacle to a separate entity for Chapter 12 estates is that the estate will not have any money to pay the taxes which may become due, unless the debtor's plan of reorganization so provides. Because the Chapter 12 trustee is little more than a disbursing agent, paying the creditors according to the debtor's plan, the trustee will not be liquidating assets or conducting a business which would generate unencumbered cash. The debtor, therefore, will be required to pay any taxes which may be incurred by the estate. In addition to the payments to creditors provided in the plan and the trustee's fee,[136] the debtor will have to anticipate and provide for the estate's taxes in the plan of reorganization.

Further practical problems and questions arise in considering the application of the separate entity rules to Chapter 12 cases. What, for instance is the period of time for which the estate is obligated to file income tax returns and pay taxes? Similar to Chapter 11 and 13 cases, all of the property of the estate vests in the debtor on confirmation of the plan.[137] If the estate is deemed to terminate on confirmation of the plan consistent with Sonner [138] and Holywell Corp.,[139] this revesting will occur within 135 days, and as little as 45 days, after the debtor files a petition in bankruptcy, limiting the time in which the estate's obligation may exist.[140] Because pre-confirmation transfers of substantial assets of the estate are generally not permitted, transfers of property to creditors will occur after the estate terminates. This termination of the estate on confirmation of the plan will cause the tax burden from transfers of property in satisfaction of debt under the plan of reorganization to be taxable to the debtor, frustrating even that potential tax benefit.

The question then is, what are the income and expenses of the estate? Chapter 7 and 11 cases report as income, "income of and from property of the estate."[141] For purposes of the payments to creditors under the plan, the Chapter 12 estate, similar to the Chapter 13 estate, but in contrast with the Chapter 7 and 11 estates, includes the debtor's postpetition earnings and after-acquired property.[142] As mentioned above, neither the Bankruptcy Code nor the Internal Revenue Code, however, relieve the debtor from the obligation to report and pay tax on this same income. Further, even if it could be said that the payments the debtor is obligated to make to the trustee for disbursement to creditors is income to the estate, the debtor is not permitted a deduction for the same amount. In addition, unless the payments under the plan are of deductible expenses, the trustee cannot deduct any such payments.

It therefore appears that both the debtor and the trustee would be obligated to report and pay tax on the income received by the debtor and paid to the trustee, without either allowed a deduction for the same, at least to the extent of payments of principal. Even though the trustee would be allowed to deduct payments of otherwise deductible expenses, both the trustee and the debtor would be required to report and pay tax on the income necessary to pay principal obligations, absent the creation of a special deduction for payments to the trustee. No legislation proposed to date suggests that the debtor will not be required to report and pay tax on postpetition income or that payments to the trustee will be deductible. Because the debtor is not relieved of the obligation to pay taxes on this same postpetition income the debtor will in effect be paying tax on the same income twice.

The problems discussed above would be greatly relieved, of course, if the estate terminates on confirmation of the plan, together with the obligation to file income tax returns and pay taxes. Because of the impossible questions raised by the inclusion of the debtor's postpetition earnings and after-acquired property in the property of the estate, the drafters of the Bankruptcy Tax Act intentionally omitted Chapter 13 cases from the separate entity rules.[143] The creation of a taxable estate with an existence of between 45 and 135 days in which few if any payments will be made to the trustee seems of little use and questionable wisdom. Further, no revenue is lost by treating the Chapter 12 case like the Chapter 13; and none gained by imposition of the separate entity rules. The administrative problems of determining income and deductions and filing returns on behalf of the estate without any benefit to anybody will only increase the workload and expenses of both the trustees and the taxing authorities.

IV. Conclusion

The suggestion that certain debtors undergoing a drastic liquidation of assets, either in bankruptcy or out, because of financial distress strikes a sympathetic note among many people. The tax consequences of asset liquidation can sometimes be harsh, particularly where the assets constitute the debtor's livelihood. The taxable liquidation is even more onerous when the debtor may be beyond the age of being able to rebuild a business or farm operation or is near retirement age. While those cases bespeak a need, any such legislative relief must be specifically identified as debtor's tax relief bill and must be available for debtors both in and out of bankruptcy. Such tax relief must not encourage bankruptcy and discourage debtor's attempts to work out their financial problems without the need to resort bankruptcy court. Further, any such relief must not adversely affect the administration of bankruptcy estates.

The proponents suggestion that abandonments of property pursuant to section 554 of the Bankruptcy Code be taxable to the estate not only is legally, technically incorrect, it is the wrong manner to solve a problem affecting only a few people. Because the property abandoned by the trustee returns to the debtor with all prepetition rights attached, as dictated by cruseturner, and because such abandonments closely approximate the non-taxable transfer of property under I.R.C. section 1398(f)(2), as so found by *McGowan* and *Olson*, the estate is not and should not be liable for the taxes incurred on the abandonment of property.

The proponents goal, to make such abandonments taxable, would produce very undesirable results. The debtor's general unsecured creditors will ultimately pay the tax bill because of 43 the priority status of the taxes. If there are insufficient funds available, as will be the case in many, if not most, cases, the trustee and the estate's lawyers, accountants, appraisers and other professional employees will share their fees with the taxing authorities. Many such professional persons including present trustees will decline to work for bankruptcy estates. The abandoned property will return to the debtor with a step-up in basis; a later sale of the property at an appreciated value would cause a much smaller tax liability. In many if not most cases, the taxes incurred will never be paid; the vast majority of cases filed are "no asset" cases. Because of the potential for income and the obligation to file returns, the trustee will find it necessary to hire a tax professional, but probably will not have the cash to pay for the services. Because a trustee will be forced to make decisions with regard to the assets of the estate with a goal to minimize taxes as opposed to maximize the return to the estate, the efficient administration of the estate will be hampered. Lastly, and perhaps most importantly, causing abandonments to be taxable to the estate makes bankruptcy a tax haven.

Section 1231(b) purports to create a separate taxable Chapter 12 estate for state income tax purposes. Presently, debtor's, Chapter 12 trustees and state taxing authorities are confused as to their respective obligations and powers as a result of the problems discussed above. Section 1231(b) is of no benefit to anyone; it should be repealed.

ENDNOTES

1. B.A. University of Iowa (1964), J.D. University of Denver (1968), LL.M. (Taxation) University of Denver (1982). Admitted to practice law in Colorado, Iowa and all pertinent Federal courts including the United States Tax Court. Member American, Colorado, Nebraska and Iowa Bar Associations. The author has written articles and has spoken at numerous seminars, workshops and meetings throughout the country on the subject of the taxation of bankruptcy and debt relief and other tax matters. The author is in private practice as a bankruptcy/insolvency tax consultant and is an Adjunct Professor of Taxation in the San Joaquin College of Law Graduate Tax Program in Fresno, California.

2. S. 1041, 101st Cong., 1st Sess. (1989) [hereinafter the "Bill"].

3. S. 2873, 100th Cong., 2d Sess. (1988).

4. Title 26, United States Code, the Internal Revenue Code of 1986 [hereinafter Internal Revenue Code or I.R.C.].

5. I.R.C. § 1001(a).

6. I.R.C. § 1001(b).

7. I.R.C. § 1012.

8. I.R.C. § 1016.

9. I.R.C. § 1014(a).

10. I.R.C. § 1015(a).

11. 284 U.S. 1 (1931).

12. I.R.C. § 61(a)(12).

13. I.R.C. § 108(a)(1)(A).

14. I.R.C. § 108(a)(1)(B).

15. I.R.C. §§ 108(a)(1)(C) and 108(g).

16. *Lutz & Schramm Co.*, 1 T.C. 682 (1943); Rev. Rul. 76-111, 1976-1 C.B. 214, *Eugene L. Freeland*, 74 T.C. 970 (1980); *Laport* v. *Comm'r*, 671 F.2d 1028 (7th Cir. 1982).

17. *Helvering* v. *Hammel*, 311 U.S. 504, 61 S.Ct. 368 (1941); *Millar* v. *Comm'r*, 577 F.2d 212 (3rd Cir. 1978).

18. 461 U.S. 300, 103 S.Ct. 1826 (1983).

19. Treas. Reg. § 1.1001-2.

20. Treas. Reg. § 1.1001-2(a) (2).

21. Treas. Reg. § 1.1017-1(b) (5).

22. Treas. Reg. § 1.1001-2.

23. I.R.C. § 108(e)(2).

24. N. Harl, Testimony submitted to the Subcommittee on Energy and Agriculture Taxation, Committee on Finance, United States Senate 8, hearing on S. 1041, July 28, 1989.

25. Most states have placed limits on the value of the homestead which may be claimed exempt. The value of the homestead exemption in California, for instance, is $45,000 for a married couple. Ann. Cal. C.C.P. § 704.730(a)(2) (West 1987 & Supp. 1989). Further, a husband and wife filing a joint petition in bankruptcy and claiming exemptions provided by the Bankruptcy Code are limited to a combined amount of $15,000. Title 11, United States Code [hereinafter the "Bankruptcy Code" or "11 U.S.C."] § 522(d) (1) (West 1989). In a few states the homestead exemption which may be claimed by debtors living outside a city or in rural areas is not limited by value but only by size: Iowa, 40 acres; Florida, Kansas, Minnesota and Oklahoma, 160 acres; and Texas, 200 acres.

26. See supra p. 3.

27. I.R.C. § 1398(f)(1).

28. I.R.C. § 1398(f)(2). The Internal Revenue Code does not define "termination" of the estate for purposes of determining when the transfer of property from the estate to the debtor shall be tax free. Nor does the Code tell us what constitutes a "transfer" for such purposes. The legislative history to the Bankruptcy Tax Act of 1980, Public Law 96-589, in which the separate entity rules of section 1398 were promulgated, does nothing to aid in the discovery of the meaning of those terms. Some of the concepts of the taxation of a Chapter 7 or 11 bankruptcy estate are sufficiently similar to the taxation of probate estates to suggest the resort to the provisions of Subchapter J of the Internal Revenue Code, the laws governing income taxes of Estates, Trusts, Beneficiaries, and Decedents. A probate estate will be considered as

terminated when all assets have been distributed except a reasonable amount set aside for payment of unascertained or contingent liabilities and expenses. Treas. Reg. § 1.641(b)-3(a). The I.R.S. has indicated that in its view a bankruptcy estate "terminates" when the case is closed. Letter from James J. Keightly, Assoc. Chief Counsel (Litigation), Internal Revenue Service to Michael L. Paup, Dep. Asst. Atty. Gen. Tax Div., Dept. of Justice (Mar. 14, 1989), n. 2. This position is inconsistent with *In re Sonner*, 53 B.R. 859 (Bankr. E.D. Va. 1985), which found that a Chapter 11 estate terminates on confirmation of the plan, generally substantially before the case is closed. The I.R.S. also says that a bankruptcy estate terminates when it is "dissolved," whenever that may be, a concept which is not found in the Bankruptcy Code and only adds confusion to the issue. See I.R.S. Publication 908, Bankruptcy and Other Debt Cancellation 4 (Rev. Dec. 88).

The concepts of "termination" of the estate and "transfer" of property to the debtor from the estate on termination more precisely comport with a Chapter 11 case. As noted above, a bankruptcy court found, in a case which arose before the effective date of the Bankruptcy Tax Act, that a chapter 11 estate terminates on confirmation of the plan of reorganization, when all of the property of the estate vests in the debtor pursuant to 11 U.S.C. § 1141(b). *In re Sonner*, supra. Confirmation of the plan occurs long before the case is closed. A Chapter 11 case will generally not be closed until after the payments under the plan have been completed.

The application of the concepts of "termination" of the estate and "transfer" of property to the debtor on such termination does not fit nearly so well. The Bankruptcy Code provides that any property scheduled under 11 U.S.C. § 521(1) and not otherwise administered at the time the case is closed is abandoned to the debtor. 11 U.S.C. § 554(c). A case is closed after the estate is fully administered and the court has discharged the trustee. 11 U.S.C. § 350(a). While in theory it might seem that Chapter 7 cases may "terminate" when closed, and that scheduled property which has not otherwise been administered will thereupon be "transferred" to the debtor, in practice the application is not so precise. The trustee's final report upon which the court enters the final decree discharging the trustee and closing the case is the last ministerial act in the case. By this time all the property of any value to the estate has been liquidated and the proceeds distributed, the estate's final income tax returns filed and taxes paid, and administrative expense requests approved. The time in which a case may be closed generally comes substantially after all of the affairs of the estate have been concluded, in all but the most simple cases. It would be the exceptional case in which any property remained subject to administration. Inasmuch as the transfer of any of the estate's remaining tax attributes, tax credits and net operating losses, which availability may lapse because of the passage of time, are transferred to the debtor on termination of the estate, such administrative ministerial delay would be unwarranted. After the estate has filed its final tax return and obtained a tax clearance under 11 U.S.C. § 505(b), the tax attributes are of no further use to the estate. The probate estate concept of termination of the estate is therefore more fitting.

29. 11 U.S.C. § 554(a).

30. 11 U.S.C. § 554(b).

31. 11 U.S.C. § 554(c).

32. *In re R.C. Machine & Tool Co.*, 816 F.2d 238 (6th Cir. 1987).

33. Id.

34. 646 F.2d 1309 (9th Cir. 1980).

35. Now I.R.C. §§ 1361 et seq.

36. 8 B.R. 581 (Bankr. D. Utah 1981).

37. Id. at 591.

38. *In re Perry*, 29 B.R. 787 (D. Md. 1983); *In re Dewsnup*, 87 B.R. 676 (Bankr. D. Utah 1988). See also *In re Bell*, 700 F.2d 1053 (6th Cir. 1983), where the Court discusses the debtor's rights of redemption and reaffirmation and the imposition of the § 362 automatic stay after the abandonment of property, citing *Cruseturner* with approval.

39. Where income from property has been received prior to the abandonment and retained by the trustee, the property has been "administered;" the debtor's prebankruptcy rights cannot be restored the estate's rights have intervened and superseded the debtor's. The abandonment of such property is therefore taxable.

40. *In re Bentley* (*Erickson* v. *United States, et al.*), Bankr. No. 83-826-C, Adversary No. 7-0042, Civil No. 87-952-E (S.D. Iowa Oct. 13, 1988), *appeal docketed*, No. 89-134351 (8th Cir. Feb. 17, 1989).

41. *In re Bentley*, 79 B.R. 413 (Bankr. S.D. Iowa 1987).

42. *In re Bentley* (*Erickson* v. *United States, et al.*), Bankr. No. 83-826-C, Adversary No. 87-0042, Civil No. 87-952-E, slip op. at 7 (S.D. Iowa Oct. 13, 1988).

43. I.R.C. § 441.

44. The Bankruptcy Tax Act of 1980, Public Law 96-589, hereinafter the "Bankruptcy Tax Act."

45. *In re McGowan*, 95 B.R. 104 (Bankr. N.D. Iowa 1988).

46. Id. at 109.

47. *In re Olson* (*Samore* v. *Olson, et al.*), Bankr. No. 85-023335, Adversary No. X88-0127S, slip op. at 10 (Bankr. N.D. Iowa, April 27, 1989), *appeal docketed*, C89-4078 (N.D. Iowa Aug. 18, 1989).

48. Id.

49. Id. at 11.

50. Another bankruptcy court decision discussed the application of I.R.C. § 1398 to property which has been abandoned during administration of the estate. *Matter of Rasmussen*, 95 B.R. 657 (Bankr. W.D. Mo. 1989). This case reasoned that the debtor's transfer of property to the bankruptcy estate on commencement of the case could arguably be characterized an exchange for the discharge of debt in "amounts which ordinarily equal or exceed the value of the property transferred, it is a transfer by exchange—the discharge of a pre-existing debt for the transfer of the property." Id. at 658-659. The Court's reasoning would, however, overrule the intent and purpose of I.R.C. § 1398(f)(1), the tax free transfer of property to the estate.

The *Rasmussen* Court is not the only court which may have misapplied the provisions of I.R.C. § 1398. The recent Tax Court decision in *William C. Lewis*, ¶ 89,078 PH Memo T.C. (1989), discussed the tax consequences of foreclosure of property at some stage during a Chapter 11 bankruptcy case without indicating the status of the property as "property of the estate," the status of the Chapter 11 case itself, precisely who held the property-at the time of the foreclosure—the debtor individually or the estate, and did not discuss the possible implications of § 1398.

51. Hereinafter the "Service" or the "IRS."

52. Letter from James J. Keightly, Assoc. Chief Counsel (Litigation), Internal Revenue Service to Michael L. Paup, Dep. Asst. Atty. Gen. Tax Div., Dept. of Justice (Mar. 14, 1989).

53. Id.

54. Id.

55. Remarks of James I.K. Knapp, Acting Ass't Att'y Gen., Tax Div., U.S. Dept. of Justice (Mar. 16, 1989). Keightly's letter also indicates that the request for guidance had been made and was under consideration for nearly one year. During this time the *Bentley*, *McGowan* and *Olson* cases were in litigation. Because the IRS was a party to the *Bentley* and *McGowan* cases and was a defendant in the *Olson* case, which were pending during this time, neither Justice Department nor the IRS was willing to publicly announce a position on the matter. The position that would be taken became apparent, however, when in the early stages of the *McGowan* litigation the IRS reversed itself and asked the court to find that the abandonment of property was not a taxable event. *In re McGowan*, 95 B.R. 104, 106 (Bankr. N.D. Iowa 1988). As a result of this change in direction and in anticipation of the formal announcement which was to follow, the United States Trustee for the Districts of Minnesota, Iowa, North Dakota and South Dakota prudently advised the panel trustees serving in those Districts that abandonments should be treated as tax free dispositions. Memorandum from Wesley B. Huisinga, United States Trustee (Jan. 5, 1988).

56. Priv. Ltr. Rul. 8918016 (Jan. 31, 1989).

57. The position on the tax consequences is obviously consistent with that of the courts and the now publicly stated IRS position.

While that now public position has strong support in law, as demonstrated by the quote from the letter from Keightly to Paup, supra note 48, the letter ruling has confused the application of the rules for the exclusion of debt discharge income under I.R.C. §§ 108 and 1017 in cases of post-abandonment foreclosure. The letter ruling has applied both the provision applicable to a discharge occurring in bankruptcy, I.R.C. § 108(a)(1)(A), and one occurring out of bankruptcy, I.R.C. § 108(a)(1)(b). The result of this misapplication is that the debtor was denied the benefit of the exclusion of debt discharge income afforded by the Bankruptcy Tax Act.

58. Nelson, *Taxation of Abandonments in Bankruptcy*, 10 J. Agric. Tax'n & L. 221 (1988) [hereinafter "Nelson"], and Harl, *Forgiving Debt in agriculture*, Agric. L. Update 4 (Aug. 1989) [hereinafter "Harl"]. Harl's article is essentially a duplication of his written testimony [hereinafter "Harl testimony"] submitted to the Subcommittee on the matter to which this testimony is addressed. Because Harl appears to represent the interests of those promoting the adoption of the legislation which he seeks, and because Harl cites Nelson in his testimony and his article with approval, at pp. 8 and 5, respectively, they are hereinafter referred to as, the "proponents."

59. In the author's experience any number of debtor's come out of bankruptcy with substantial exempt property or earning power and ability to pay the taxes in question. These individuals, along with the few truly unfortunate debtors, would benefit from a taxable abandonment; those with the ability to pay these deferred taxes would not be excluded from the relief. In addition, the proponents have not indicated whether or not any of the debtors for whom they advocate the taxable abandonment have attempted to resolve their post-foreclosure tax problems by means of an offer in compromise provided under I.R.C. § 7122. The impact of these taxes may have been alleviated somewhat by the recent liberalization of the taxpayer's property exempt from tax levy, to include the taxpayer's homestead, among other changes. I.R.C. § 6334(a)(13).

There have been, and will continue to be, a few truly egregious cases which may merit relief. The author's concern, however, is that the proposed solution, that all abandonments by a trustee in bankruptcy be treated as taxable sales, not only is contrary to the fundamental purposes of bankruptcy, but would severely and adversely affect the administration of the estate.

60. S. Rep. No. 989, 95th Cong., 2d Sess. 76 (1978); H.R. Rep. No. 595, 95th Cong., 1st Sess. 362 (1977).

61. S. Rep. No. 989, 95th Cong., 2d Sess. 98 (1978); H.R. Rep. No. 595, 95th Cong., 1st Sess. 384 (1977).

62. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 [hereinafter the "Bankruptcy Act"].

63. 11 U.S.C. § 522(d).

64. 11 U.S.C. § 522(b)(2)(A).

65. I.R.C. § 523(a)(1).

66. See 3 Collier on Bankruptcy, 15th Ed., ¶ 523.06, (1989).

67. See, e.g., *United States* v. *Bernstein,* 16 F.2d 233 (8th Cir. 1929).

68. 11 U.S.C. §§ 523(a)(1)(A) and 507(a) (7).

It is worth noting that the Bankruptcy Code treats taxes incurred after the filing of an involuntary petition under 11 U.S.C. § 303, but before the appointment of a trustee or an order for relief is entered, the "gap period," as prepetition taxes and therefore not dischargeable. 11 U.S.C. § 523(a)(1)(A). See also 3 *Collier on Bankruptcy,* 15th Ed., ¶ 523.06[1] (1989).

69. Karl testimony, supra note 58, at 7.

70. 11 U.S.C. § 554(c).

71. Nelson, supra note 58, at 236.

72. *Crane* v. *Comm'r,* 331 U.S. 1 (1947).

73. *Commissioner* v. *Tufts,* 461 U.S. 300, 103 S.Ct. 1826 (1983).

74. Nelson, supra note 58, at 235.

75. Nelson, supra note 58, at 241; Karl, supra note 58, at 5; and Karl testimony, supra note 58, at 8.

76. 11 U.S.C. § 506(a).

77. 11 U.S.C. § 502(b).

78. 11 U.S.C. § 1129(a)(7)(A)(ii), the "cram down" provisions.

79. *K.C. Machine & Tool Co.,* 816 F.2d 238 (6th Cir. 1987). See also *In re Poage,* 92 B.R. 659 (Bankr. N.D. Tex. 1988).

80. 11 U.S.C. § 363(b).

81. 77 T.C. 310 (1981), aff'd 693 F.2d 124 (11th Cir. 1982).

82. 737 F.2d 479 (5th Cir. 1984).

83. 11 U.S.C. § 541(a).

84. *Matter of Rasmussen,* 95 S.R. 657 (Bankr. W.D. Mo. 1989), discussed in more detail, supra note 50.

85. Nelson, supra note 58, at 241.

86. The release of an interest in property by quit claim deed would be comparable if the grantor has no interest to convey and under State law the quit claim of property is not a conveyance; the quit claim of the property is a means of clearing title, for example. In that case no transfer of property occurs. A transfer does occur, however, where the use of a quit claim deed is a release of an interest in property with the intent that the grantee shall take whatever rights and interests were held by the grantor and the grantor in fact held an interest in the property.

87. Should the creditor file a claim for the full amount of the debt and not give credit for the value of the property abandoned, the trustee may bring an action in bankruptcy court, under 11 U.S.C. § 506(a), to determine the value of the property subject to the secured claim and deny the claim as appropriate.

The abandonment of property by a trustee in bankruptcy can be analogized with a debtor outside of bankruptcy who vacates or abandons a building subject to recourse indebtedness, intending that the creditor will foreclose and the debt will be paid. Unless the creditor agrees otherwise, until the foreclosure is complete and the proceeds from the sale applied in full or partial satisfaction of debt, the debtor's act of vacating the premises does not affect the creditor's claim—the debtor is still liable for the full amount of the debt. Should the building be destroyed prior to foreclosure the debtor cannot claim any benefit because of its former value. The debtor will not benefit from his abandonment of the property until the foreclosure sale. Absent a discharge in bankruptcy, the debtor's property and future earnings are subject to the claims of creditors on recourse debt. In contrast with the debtor's unlimited liability, the estate is only liable for recourse debt to the extent of its unencumbered assets.

88. See supra p. 14 & note 56.

89. 11 U.S.C. §§ 521(2)(A), 524(c).

90. In the author's experience in representing debtors in the Midwest, good prebankruptcy planning included the use of "friendly debt" to reduce any equity in property so that abandonment would be assured and, thus, the debtor would be able to retain the property.

91. *Milledge L. Middleton*, 81 T.C. 310 (1981), aff'd 693 F.2d 124 (11th Cir. 1982).

92. *Commissioner* v. *Yarbro*, 737 F.2d 479 (5th Cir. 1984).

93. A similar concept applies as a result of the debtor's discharge. Not only does the creditor's lien on secured property survive the debtor's discharge, but so does the debt. Enforcement of the debt against the debtor personally, however, is prohibited as a result of the discharge. *In re Berry*, 85 B.R. 367, 369 (Bankr. W.D. Pa. 1988) (The discharge is not a payment or extinguishment of the debt itself; it simply bars future legal proceedings to enforce the discharged debt against the Bankrupts).

94. As discussed earlier, gain on a taxable disposition of property is measured by the excess of amount realized over basis. I.R.C. § 1001(a). The amount realized, the amount of money and fair market value of any property received in the transaction, is the consideration for the sale. Numerous court decisions including *Milledge L. Middleton*, 77 T.C. 310 (1981), discuss the necessity of an exchange of consideration in a taxable sale.

95. Nelson, supra, at 237.

96. Id.

97. See the discussion of *In re Sonner*, 53 B.R. 859 (Bankr. E.D. Va. 1985), supra note 28.

98. *In re Sonner*, 53 B.R. 859 (Bankr. E.D. Va. 1985); *In re Holywell Corp.*, 85 B.R. 898 (Bankr. S.D. Fla. 1988).

99. The *Olson* and *McGowan* decisions also achieve this parity, but without relying on *Cruseturner*. If the *Olson* and *McGowan* analysis is correct the justification for the result reached is found in the *Cruseturner* holding.

100. Nelson, supra note 58, at 238.

101. See *In re Dewsnup*, 87 S.R. 676 (Bankr. D. Utah 1988), where the court discussed the implications of an abandonment to someone with a possessory interest, within the context of the legislative history. See H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 377 (1977); 5. Rep. No. 95-989, 95th Cong., 2d Sess. 92 (1978).

102. See generally Uniform commercial code §§ 9-104, -304, -305.

103. In a paper presented at the Northwest Bankruptcy Institute, Judge Polly S. Higdon, United States Bankruptcy court, Eugene, Oregon, examined the bankruptcy court's power to order that property be abandoned directly to a specific creditor. Judge Higdon concluded that the bankruptcy court does not have the power, under 11 U.S.C. § 554, to order property be abandoned to anyone other than the debtor. "Section 554 was not intended to effect changes in the substantive rights of the parties in property." Hon. P. Higdon, Tax Problems of Abandonment of Property in Bankruptcy (Jan. 21, 1989) (seminar materials for the Northwest Bankruptcy Institute, Portland, Ore. Jan. 21, 1989).

104. Harl, supra note 58, at 6; Harl testimony, supra note 58, at 12–14.

105. I.R.C. § 168.

106. 11 U.S.C. §§ 503(a)(1), 507(a)(1).

107. 11 U.S.C. §§ 726(b), 507(a)(1), 503(b).

108. *In re Barron*, 73 B.R. 812 (Bankr. S.D. Cal. 1987).

109. *In re Tri-County Water Assoc. Inc.*, 91 B.R. 547 (Bankr. D. S.D. 1988); *Lavender* v. *Wood Law Firm*, 785 F.2d 247 (8th Cir. 1986); and *In re Burnside Steel Foundry Co.*, 90 B.R. 942 (Bankr. N.D. Ill. 1988)

110. The value of Iowa farm land, for instance, apparently has recently appreciated substantially, by as much as 23% since March 1, 1989 alone. The Des Moines Register, Sept. 7, 1989, at 6.

111. See infra note 114, for a discussion of the debtor's transferee liability and the discharge from the estate's taxes.

112. 111 U.S.C. § 505(b).

113. 11 U.S.C. § 522(b); S. Rep. No. 95-989, 95th Cong. 2d Sess. 91 (1978).

114. The Bankruptcy Code at § 505(b) provides that upon payment of the estate's tax, the debtor is discharged from any liability for such tax. Legislative history indicates that if the trustee does not avail himself of the prompt audit procedures of § 505(b), the debtor would not be discharged from possible transferee liability if any "surplus assets" are returned to the debtor. S. Rep. No. 95-989, 95th Cong. 2d Sess. 68 (1978). I.R.C. § 6901(a)(1) provides that the liability, at law or in equity, of a transferee of property of a taxpayer may be collected from such transferee. Bankruptcy Code § 505(b) does not specifically provide for such transferee liability "at law," and the claim of the debtor's exemptions in bankruptcy does not display any of the "badges of fraud" so as to impose transferee liability "in equity." Further, Treasury Regulations defining a "transferee" does not identify debtors in bankruptcy. Treas. Reg. § 301.6901-1(b). However, under the circumstances, it may be possible to conclude that the debtor theoretically will incur such liability, but only to the value of any unadministered or excess property remaining after payment of claims which is abandoned back to the debtor. See *Phillips* v. *Comm'r*, 283 U.S. 589 (1931); *Drew* v. *United States*, 367 F.2d 828 (Ct. Cl. 1966). However, as indicated, upon the recognition of the debtor's claim of exemption, such property is "exempted from" the estate, as opposed to having been transferred by the estate. A "transfer" by definition requires the affirmative act of a "transferor," a "transferee" is "one to whom a transfer is made." The New Webster Encyclopedic Dictionary 887 (1980 ed. 1977). While the debtor affirmatively claims such property as exempt, the trustee takes no action with regard to the claim unless an objection is made. 11 U.S.C. § 522(l). Transferee liability will therefore not be imposed on the debtor because of the claim of exempt property.

In a reorganization case, legislative history indicates that the debtor or a successor to the debtor may remain liable for a deficiency for additional taxes due on returns filed during the title 11 proceedings, however, no mechanism other than transferee liability is provided for collection of such taxes. See S. Rep. No. 95-989, 95th Cong., 2d Sess. 68 (1978).

115. 11 U.S.C. §§ 522(k), 503(b)(1)(B).

116. 11 U.S.C. §§ 523(a)(1)(A), 507(a)(1)(A).

117. Bankruptcy estates of individuals under Chapter 7 or 11 are required to file Federal income tax returns when gross income equal to the exemption amount plus the basic standard deduction is received during the taxable year. I.R.C. § 6012(a)(9). For taxable years beginning in 1989 that amount is $4,500.

118. I.R.C. § 6012(a)(9).

119. *In re Wills*, 56 AFTR2d 85-5016 (Bankr. D. Md. 1985).

120. 31 U.S.C. § 3713(b), the Federal priority statute.

121. See *United States* v. *Golden Acres, Inc.*, 684 F. Supp. 96 (D. Del. 1988); *United States* v. *Vertac Chemical Corp.*, 671 F. Supp. 595; (E.D. Ark. 1987) *United States* v. *Excellair, Inc.*, 637 F. Supp. 1377 (D. Colo. 1986).

122. See *In re Joplin*, 882 F.2d 1507 (10th Cir. 1989).

123. In *re K.C. Machine & Tool Co.*, 816 F.2d 238 (6th Cir. 1987).

124. See supra p. 30.

125. 11 U.S.C. § 507(a)(7).

126. S. Rep. No. 96-1035, 96th Cong. 2d Sess. 26 (1980).

127. 11 U.S.C. §§ 507(a)(7) and 523(a)(1)(A).

The result is really no different than if the debtor were to liquidate outside of bankruptcy. In that case the assets would be sold and the proceeds distributed to the creditors. The taxes shown on an income tax return filed the following April 15th would be paid out of what ever was left over from the sale of assets. If the remaining proceeds were insufficient, the debtor would remain liable for the unpaid taxes.

128. See generally 11 U.S.C. § 109.

129. This result presumes that the farmer has not elected, pursuant to I.R.C. § 77, to report the corn loan as income when received.

130. Harl Testimony, supra note 58, at 14; Harl, supra note 58, at 6.

131. Harl Testimony, supra note 58, at 16; Harl, supra note 58, at 7.

132. Shepard, *Taxation Of Chapter 12 Cases*, (April 1987), Norton Bankruptcy Law Adviser, Callaghan & Company; Shepard, *Section 1231(b): An Examination Of The Trustee's Obligation To File State Income Tax Returns*, (May 1988), Norton Bankruptcy Law Adviser, Callaghan & Company; Shepard, *A Trio Of Tax Topics*, (June 1988), Norton Bankruptcy Law Adviser, Callaghan & Company.

133. The number of debtors potentially effected by the proposed addition of Chapter 12 cases to the provisions of I.R.C. § 1398 is rapidly dwindling. Table 1, Harl tes-

timony at 15, purports to reflect the "Chapter 12 Filings in the North Central Region Since November 26, 1986." The Table appears without explanation or source attribution. Information supplied by the clerks of courts from within the States to which the Table purports to relate indicates that the Table apparently is a cumulative tabulation of Chapter 12 bankruptcy *filings*. The Table, however, does not account for cases converted, dismissed or confirmed—it does not even approximate the number of pending cases. According to information supplied to the author, Chapter 12 cases filed during the period from January through August 1989 are as follows: Iowa 18 cases; Nebraska 55 cases; North Dakota 29 cases; South Dakota 53 cases. In Minnesota 36 cases were filed during the first 7 months of 1989. The statistics further reveal that the rate of filings per month continues fall to one or two cases in most of the districts and no cases in some of the districts.

134. Unless due to a mere change in the form of doing business, the premature disposition or cessation of qualified use of section 38 property, property on which investment tax credit had been allowed, will be a recapture event. Treas. Reg. § 1.47-3(f)(1). Because of the repeal of I.R.C. § 38 by the Tax Reform Act of 1986, Pub. L. 99-514, under which investment tax credit was allowed, any issue of the debtor's liability for recapture of investment credit because of filing a petition under Chapter 12 of the Bankruptcy Code will ultimately disappear; the property on which the credit was allowed will eventually all have been held for the requisite amount of time.

135. The issue of whether a bankruptcy estate of a case filed prior to the Bankruptcy Tax Act is required to file Federal income tax returns and pay taxes continues to be litigated. See, e.g., *In re Joplin (United States v. State Farm Fire & Casualty Co.)*, 882 F.2d 1507 (10th Cir. 1989). Cases litigating the issue have been Chapter 7 cases or Chapter 11 cases converted to Chapter 7. However, because the provisions Chapter 12 of the Bankruptcy Code were adopted in large part in reliance of Chapter 13 which was specifically omitted from the application of I.R.C. § 1398, see H.R. Rep. No. 96-833, 96th Cong. 2d Sess. 20 (1980) and S. Rep. No. 96-1035, 96th Cong. 2d Sess. 25 (1980), and because Chapter 12 was adopted by the same Congress which passed the Tax Reform Act of 1986, Pub. L. 99-514, without amending § 1398 to include Chapter 12 cases, neither Chapter 12 nor Chapter 13 cases are required to file Federal income tax returns or pay such taxes. For a full discussion of the Chapter 12 estates obligation to file State and Federal income tax returns, see *Shepard, Taxation Of Chapter 12 Cases*, Norton Bankruptcy Adviser (April 1987) and Shepard, *Section 1231(b): An Examination Of The Trustee's Obligation To File State Income Tax Returns*, Norton Bankruptcy Adviser (May 1988).

136. The trustee of a Chapter 12 case is to receive a fee of no more than 10% of the payments in an aggregate amount of $450,000, plus no more than 3% of the aggregate payments in excess of $450,000. 28 U.S.C. § 586(e)(1)(B)(ii); 11 U.S.C. § 1226(a)(2).

137. 11 U.S.C. §§ 1141(b), 1227(b), 1327(b).

138. *In re Sonner*, 53 B.R. 859 (Bankr. E.D. Va. 1985).

139. *In re Holywell Corp.*, 85 B.R. 898 (Bankr. S.D. Fla. 1988).

140. 11 U.S.C. §§ 1221, 1224.

141. 11 U.S.C. § 541(a)(6); I.R.C. § 1398(e)(1), (f)(1).

142. 11 U.S.C. §§ 1207(a), 1306(a).

143. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 25, n. 3 (1980).

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